

# Spotlight on south-eastern Europe



European Bank  
for Reconstruction and Development

An overview of private sector activity and investment



# Guide to readers

## Country groupings

The publication uses the following collective terms to refer to country groupings:

South-eastern Europe (SEE)	Albania, Bosnia and Herzegovina, Bulgaria, Croatia, FYR Macedonia, Moldova, Romania and Serbia and Montenegro.
Central Europe and the Baltic states (CEB)	Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Slovak Republic and Slovenia.
Commonwealth of Independent States (CIS)	Armenia, Azerbaijan, Belarus, Georgia, Kazakhstan, the Kyrgyz Republic, Moldova, Russia, Tajikistan, Turkmenistan, Ukraine and Uzbekistan.

Note that in this study, Croatia is included in SEE rather than in CEB (as in other EBRD publications) and Moldova is included in both SEE and the CIS.

## Abbreviations

The Bank, EBRD	The European Bank for Reconstruction and Development
BEEPS	Business Environment and Enterprise Performance Survey
CEB	central Europe and the Baltic states (see country groupings above)
CIS	Commonwealth of Independent States (see country groupings above)
EU	European Union
FDI	foreign direct investment
FRY	Federal Republic of Yugoslavia
FTAs	free trade agreements
FYR	Former Yugoslav Republic
GDP	gross domestic product
IFI	international financial institution
IFS	International Financial Statistics
IMF	International Monetary Fund
OECD	Organisation for Economic Cooperation and Development
PPP	purchasing power parity
SAA	Stabilisation and Association Agreement
SAP	Stabilisation and Association process
SEE	south-eastern Europe (see country groupings above)
SMEs	small and medium-sized enterprises
UN	United Nations
WTO	World Trade Organization

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# Foreword

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This publication charts the current level of private sector development and investment activity in the eight transition countries of south-eastern Europe (SEE) – Albania, Bosnia and Herzegovina, Bulgaria, Croatia, FYR Macedonia, Moldova, Romania, and Serbia and Montenegro. These countries are among the 27 transition countries where the European Bank for Reconstruction and Development (EBRD) operates.

The EBRD seeks to foster the transition to an open market-oriented economy and to promote private and entrepreneurial initiative in all of its countries of operations. It works with its partners on projects that are financially sound and that advance the transition process. Many of these projects would be unlikely to emerge or to function well without its participation. For the EBRD to perform this task effectively, it needs to analyse and understand the process of transition. This publication is designed to advance our knowledge of transition in a region where the EBRD's activities have grown strongly in recent years and where, within the Stability Pact for south-eastern Europe, the Bank plays the lead role in private sector development.

South-eastern Europe is a complex, diverse region with a difficult recent history. The violent break-up of the Socialist Federal Republic of Yugoslavia (SFRY) at the beginning of the 1990s was followed by several years of turmoil and conflict, which adversely affected the transition process throughout the whole region. The last major conflict was in Kosovo in 1999 and resulted in the province being placed under provisional United Nations administration. Since then, the region has made significant progress and achievements have far out-numbered setbacks. The region's economies are growing, inflation is coming

down, foreign investors are showing increasing interest, and cooperation within the region has advanced to levels that were hard to imagine five years ago. While many problems remain to be tackled and risks are still high, the future for the region looks increasingly bright. Bulgaria and Romania are candidates for EU membership in 2007 and Croatia may start EU accession negotiations soon. For the remaining countries, there is hope, and indeed the expectation in most cases, that they too will eventually become EU members.

Private sector development is at the heart of a successful transition, and it is essential for reducing unemployment and poverty, which blight large parts of south-eastern Europe. This publication takes stock of the current state of the private sector in the region and of the obstacles that may prevent the private sector from developing further. Four key ingredients for a successful transition are an attractive business environment, access to finance, foreign direct investment and international trade. The region has made rapid progress in recent years in all four areas but on average it still lags behind the more advanced transition countries in central Europe and the Baltic states (CEB) that are about to join the European Union. The region is catching up but it still has a long way to go. This publication will, I believe, contribute to our understanding of how this catch-up process can be accelerated.



**Willem Buiter**  
EBRD Chief Economist and  
Special Counsellor to the President



# Introduction and executive summary

# 1

South-eastern Europe (SEE), often still referred to as the “Balkans”, is a region of opportunity and potential, although throughout the 1990s few people would have agreed. The region went through a major political and economic upheaval during that period, leaving it with an enduring reputation for instability. However, since then there has been more good news than bad, and there are grounds for optimism about the medium- to long-term future of SEE. Many problems, risks and challenges remain, but it is possible now to be confident, rather than merely hopeful, that these can and will be overcome.

The progress made since the late 1990s has, in many ways, been remarkable. In early 1999, much of the region was still in a state of turmoil. The then Federal Republic of Yugoslavia (FRY), under the autocratic regime of Slobodan Milosevic, was a destabilising influence at the heart of SEE. Escalating tensions in the FRY province of Kosovo culminated in military intervention by the North Atlantic Treaty Organisation (NATO) in March 1999 and a 78-day campaign against Serbian forces.<sup>1</sup> The conflict also resulted in the disruption of transport routes along the Danube, particularly affecting Bulgaria and Romania, in lower tourism revenues in Croatia, and in massive temporary migration flows of ethnic Albanians from Kosovo to neighbouring countries, mainly Albania and the Former Yugoslav Republic (FYR) of Macedonia. At that time, prospects for the whole region looked bleak.

However, from the viewpoint of early 2004, the picture has changed radically. The fall of the Milosevic regime in October 2000 allowed the FRY (since renamed the State Union of Serbia and Montenegro in February 2003) to rejoin the international

community, including international financial institutions (IFIs). All countries in the region are cooperating bilaterally and in regional forums to an extent that was unimaginable five years earlier. Reforms are proceeding steadily in each country, if somewhat slowly in a few cases, and all economies are growing, some of them quite rapidly. Two of the larger countries, Bulgaria and Romania, are candidates for accession to the European Union (EU) in 2007. The region is starting to catch up with transition countries<sup>2</sup> in central Europe and the Baltic states (CEB).

Future prosperity requires a vigorous, growing private sector. This study reviews the state of private sector development in SEE, evaluates the prospects for matching the economic performance of more advanced regions, and analyses what needs to be done to achieve this goal. The private sector accounts for more than half of economic activity in most countries of the region, and is expected to grow further. The state still has a crucial enabling role, but most production decisions are no longer taken or directed centrally. The support of bilateral and multilateral institutions and donors will be needed for years to come in selected areas. However, if progress in the region is sustained, their role as a catalyst for transition and development is expected to evolve over the medium-term.

This study also has a strong focus on investment. The region needs much more investment from domestic and foreign sources. Without it, economic recovery will stall, resulting in low economic growth and, in some cases, continued high levels of unemployment and poverty. Since the start of transition, domestic sources of investment have been held back by the low level of lending to enterprises, although the

situation has been improving, especially in the more advanced countries of the region. Foreign investors have shown some interest in SEE – cumulative net foreign direct investment (FDI) to the region between 1989 and 2003 is about US\$ 32 billion – but these inflows are well below the amounts that have gone to CEB (about US\$ 125 billion).

In growing economies there are many opportunities for profitable trade and investments. For these to be realised, however, countries need to tackle the persistent problems and obstacles that face enterprises in their day-to-day activities. This study analyses these obstacles, evaluates the impact of existing measures to overcome them and proposes ways in which the situation can be improved further.

## 1.1 What is south-eastern Europe?

For this study, SEE covers Albania, Bosnia and Herzegovina, Bulgaria, Croatia, FYR Macedonia, Moldova, Romania, and Serbia and Montenegro.<sup>3</sup> Despite their many differences, these eight countries share certain common characteristics: they are all transition countries; they are not members of the EU at this time, nor are they among those countries joining in May 2004; and they are recipient members of the Stability Pact for South Eastern Europe.<sup>4</sup>

Can these eight countries be viewed as a “region”? Historically, the answer must be no. When the Ottoman and Habsburg empires broke up at the end of the First World War, the countries of SEE joined different groupings and the region remained quite divided. The formation of the Socialist Federal Republic of Yugoslavia (SFRY) after the Second World War led to an enforced

<sup>1</sup> Following the hostilities, and in line with United Nations Security Council Resolution 1244, Kosovo remains part of the territory of Serbia and Montenegro but has been under interim UN administration since June 1999, pending a resolution to its final status. This study does not contain any separate analysis of the province.

<sup>2</sup> Transition countries are in the process of transforming their economies from ones based mainly or completely on state or social ownership to ones where private enterprises can flourish and market principles apply across most sectors.

<sup>3</sup> This definition is wider than that used in other EBRD publications, such as the *Transition Report*, where Croatia is included with CEB and Moldova is grouped with the rest of the Commonwealth of Independent States (CIS). These eight countries are “countries of operations” of the EBRD, meaning that they are eligible for, and receive, EBRD investments, in both the public and private sectors.

<sup>4</sup> The Stability Pact for South Eastern Europe was adopted by more than 40 partner countries and organisations in Cologne on 10 June 1999, and re-affirmed at a summit meeting in Sarajevo on 30 July 1999. For more information on the Stability Pact, see <http://www.stabilitypact.org/>.

Table 1.1

## Macroeconomic indicators, 2003

	Per capita GDP (in US\$)	Per capita GDP <sup>1</sup> (at PPP exchange rate)	Real GDP growth (% change)	Consumer prices (end-year, % change)	Unemployment <sup>2</sup> (end-year, % of labour force)	Consolidated general government balance (% of GDP)	Current account / GDP (in per cent)	External debt / GDP (in per cent)
Albania	1,764.9	3,781.0	6.0	3.6	15.8	-5.6	-8.4	23.2
Bosnia and Herzegovina	1,857.3	5,970.0	3.5	0.1	40.6	0.3	-17.8	34.7
Bulgaria	2,504.9	6,890.0	4.5	5.6	18.2	0.0	-8.3	57.2
Croatia	6,408.6	9,170.0	4.5	1.8	14.8	-4.6	-6.8	83.5
FYR Macedonia	2,357.3	6,110.0	2.8	2.5	31.9	-1.6	-6.3	36.1
Moldova	450.7	2,150.0	6.3	15.8	7.4	0.2	-8.0	89.2
Romania	2,519.6	5,830.0	4.9	14.1	8.2	-2.4	-6.1	35.7
Serbia and Montenegro	2,506.6	2,950.0	2.0	7.7	28.9	-2.5	-11.6	68.5
CEB	7,157.3	11,446.3	3.6	3.2	12.0	-3.3	-5.7	54.3
SEE	2,546.2	4,987.6	4.3	6.3	20.7	-2.0	-9.2	53.5
CIS	1,106.3	4,061.6	7.6	9.1	4.7	-1.2	-2.0	52.7

Source: EBRD staff estimates.

<sup>1</sup> Per capita GDP data from 2001, except Serbia and Montenegro which are 2000.<sup>2</sup> Unemployment rate for end-2002.

cooperation between the constituent republics of the new country, but relations among all the countries of the region were limited. Albania adopted an increasingly isolated policy until 1990, Bulgaria and Romania were firmly in the Soviet sphere of influence, and Moldova was one of the republics of the Soviet Union.

Given SEE's history, few people in these countries would regard themselves as part of a coherent regional entity.<sup>5</sup> Nevertheless, Western institutions, including the European Commission, regularly emphasise the importance of intra-regional cooperation, especially on economic issues such as trade, transport infrastructure and investment. There are encouraging signs that SEE countries are willing to take a pragmatic approach and cooperate with each other when the benefits to all sides of doing so are clear.

Two examples illustrate this point. The first is the signing of bilateral free trade agreements among all countries of the region (except Moldova, which is on a later timetable). As explained in detail in Chapter 5, more needs to be done to ensure that what has been agreed on paper is acted upon, providing for a genuinely freer flow of goods. Nevertheless, these initial agreements are a positive start. The second

example is the signing by all countries in SEE of a Memorandum of Understanding (MoU) on the creation of a regional electricity market by 2005 (see Chapter 5). Such examples augur well for future cooperation.

### The European perspective

Accession to the EU is high on the agenda of countries in SEE. At the forefront in the process are Bulgaria and Romania. Both countries were informed officially in December 2002 that they would not be part of the wave of accession scheduled for 1 May 2004. Instead, they were given a target date of 1 January 2007, and are working to complete negotiations on the body of EU laws known as the *acquis communautaire* by the end of 2004. Bulgaria was further advanced in this regard than Romania in terms of the number of provisionally closed chapters of the *acquis* (26 in Bulgaria versus 22 in Romania) by the end of 2003.

For the five countries of the western Balkans – Albania, Bosnia and Herzegovina, Croatia, FYR Macedonia, and Serbia and Montenegro – the EU has devised the Stabilisation and Association process (SAP). Part of this process involves the negotiation of Stabilisation and Association Agreements (SAAs), which include the

gradual implementation of a free trade area and the harmonisation of national legislation with EU standards. However, no target date for their accession has yet been set. Croatia (which applied for EU membership in February 2003 and awaits a response) and FYR Macedonia have signed SAAs with the EU.<sup>6</sup> The other three countries are further behind in the process; negotiations on a SAA are ongoing with Albania, but as of early 2004 they had not yet started with Bosnia and Herzegovina or Serbia and Montenegro. Moldova is part of the European Commission's "Wider Europe" initiative.<sup>7</sup>

## 1.2 Recent economic developments

### Macroeconomic performance

The main macroeconomic developments in the region are described comprehensively in a number of publications and are summarised only briefly below.<sup>8</sup>

Table 1.1 contains summary data for a variety of macroeconomic indicators. Living standards vary widely across the countries of the region. Column 1 in the table shows estimates for 2003 of gross domestic product (GDP) per capita in US dollars. This is a highly imperfect measure of economic well-being, not least because, as explained in the next chapter, official estimates of

<sup>5</sup> See, for example, the comprehensive account by Anastasakis and Bojicic-Dzelilovic (2002) of local, mostly negative perceptions of regional cooperation in SEE. The conclusions are based on the authors' recent fieldwork in the region.

<sup>6</sup> The Government of FYR Macedonia intended to submit a formal application for EU membership on 26 February 2004, but the event was postponed following the death that morning of the country's President, Boris Trajkovski.

<sup>7</sup> See Communication from the Commission to the Council and the European Parliament COM (2003) 104 Final: "Wider Europe – Neighbourhood: A New Framework for our Relations with our Eastern and Southern Neighbours", available at [http://europa.eu.int/comm/external\\_relations/we/intro/ip03\\_358.htm](http://europa.eu.int/comm/external_relations/we/intro/ip03_358.htm).

<sup>8</sup> See, for example, EBRD (2003).



GDP often fail to reflect activity in the informal sector. Nevertheless, it is quite striking that Croatia has a GDP per capita more than ten times that of Moldova. These two countries are at opposite ends of the spectrum; the other six are bunched more closely together, averaging close to US\$ 2,200 per capita. When these estimates are adjusted for differences in purchasing power (see column 2), the difference between Croatia and Moldova narrows, but the main conclusions remain the same.

Encouragingly, all economies in the region are expanding, and inflation is broadly under control. Column 3 shows that real GDP growth in the region in 2003 averaged around 4 per cent, well above that of either CEB or the single-currency area (the “eurozone”) of the EU. This was the third year in a row where growth in SEE was higher than in CEB. Annual (end-year) inflation was in single figures in all countries except Moldova and Romania (see column 4). In the former, the jump in inflation in 2003 was partly caused by a sharp rise in food prices, while inflation is declining in Romania under a carefully managed policy of modest real appreciation of the local currency.

Several cautionary points should be made here. First, it would take many years of these kinds of growth differentials for the region to catch up with CEB. Second, while low inflation is important for stability and confidence, the benefits of any further reductions are likely to be limited. Third, there remains a persistent problem of unemployment in the region. Column 5 shows that two countries have unemployment rates in excess of 30 per cent of the labour force. Some people who are reported to be without a job may in fact be doing some part-time or casual labour in the informal sector, but many are long-term unemployed with little prospect of getting work again. In some countries, ongoing public sector reforms and post-privatisation restructuring are adding to the already high unemployment levels.

Columns 6 and 7 highlight two key medium-term macroeconomic challenges facing the region – the control of fiscal deficits and

the reduction of current account deficits. At present, the fiscal accounts are in reasonable shape, with most countries having either a surplus or only small deficits. However, the fiscal challenges for the medium term are quite daunting. For Bulgaria and Romania, the costs of meeting the standards and obligations of the *acquis communautaire* are substantial, although significant pre-accession funds are available from the EU for this purpose. The current high fiscal deficits in several CEB countries show how difficult it is to manage spending during the run-up to EU accession. For the rest of the SEE region, the main fiscal risk lies in declining sources of official aid. Spending will have to fall unless new sources of revenue can be found. It would help the governments’ finances if untaxed activities in the informal sector could be brought into the formal sector – for more on which see Chapter 2.

On the external side, trade and current account deficits are typically high throughout the region, the latter ranging from 6.1 per cent of GDP in Romania to 17.8 per cent in Bosnia and Herzegovina. High current account deficits are common in transition countries, especially those undergoing major restructuring and needing large capital inflows. In several SEE countries, they also reflect the limited openness to trade and the barriers faced by exporters (see Chapter 5). However, deficits of these magnitudes cannot be sustained indefinitely. Whether the adjustment to smaller deficits is made through lower imports or through export-led growth depends largely on the degree of progress in private sector development.

Finally, column 8 in Table 1.1 shows the level of external debt, expressed as a percentage of GDP. Moldova is in the most precarious position, with a debt to GDP ratio close to 90 per cent. The country has a recent history of arrears and re-scheduling of debt repayments and this fact, along with the current absence of an International Monetary Fund (IMF) programme raises fears that the country will have great difficulty in servicing its debts in the future. Elsewhere, debt levels appear to be moderate in most cases.

However, in all countries, the scope for absorbing new foreign debt is limited. Several face rising levels of debt servicing in the second half of this decade, as grace periods on concessional loans draw to a close.

## Progress in transition

Transition in SEE has been slower and more difficult than in CEB. Nevertheless, there has been a new momentum in reforms, in line with the improved economic situation. Progress in reforms is more difficult to measure than macroeconomic variables, such as growth or inflation.

Some reforms are usually carried out early in transition, including small-scale privatisation, price liberalisation, and trade and foreign exchange liberalisation. Other reforms are more difficult, such as large-scale privatisation, governance and enterprise restructuring, competition policy, development of the banking sector, security markets and non-banking financial institutions; and infrastructure reform. Every year the EBRD *Transition Report* provides numerical scores – see Chart 1.1 – that attempt to capture where countries stand on each of these reform indicators. The scores range from 1, which represents little or no change from a planned economy, to 4+, which represents the standard of an advanced market economy.<sup>9</sup> These scores allow the measurement and comparison, if rather crudely, of relative progress in transition across countries and time.

The chart shows the average transition score in 2003 for each transition country. Croatia is the most advanced country in SEE and is at a stage of transition that is comparable to most EU accession countries. Bosnia and Herzegovina and Serbia and Montenegro lag behind. Both countries started their transition later than most and, despite some catching up, still have ground to make up. A more detailed breakdown of reforms into first phase (those carried out early in transition) and second phase (institutional reform) shows the slow pace of the latter throughout the region.<sup>10</sup> Accelerating this process is a major medium-term challenge. Early reforms in transition by themselves bring

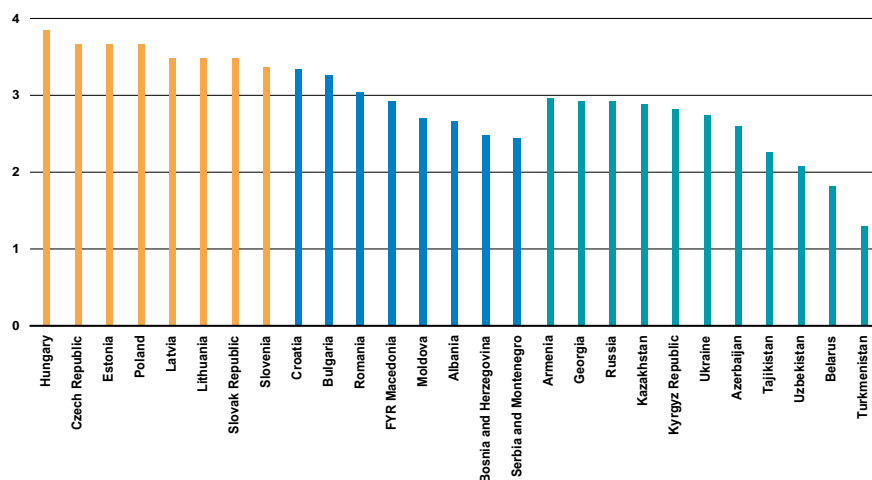
<sup>9</sup> These are ordinal indexes, and therefore the scores are not directly comparable across different dimensions of transition. That means that moving from a score of 1 to 2 is not necessarily the same as moving from 3 to 4, and a score of 3 in one dimension – for example, price liberalisation – is not equivalent to a 3 in another reform area. In calculating within-country averages, scores with a plus or minus attached are translated into numerical values by adding or subtracting 0.33, so 2+ becomes 2.33 and 3- becomes 2.67.

<sup>10</sup> See EBRD (2003, Chapter 2).

Chart 1.1

## Average EBRD transition scores, 2003

Average EBRD transition score



CEB SEE CIS

Source: EBRD Transition Report, 2003.

Note: The average transition score ranges from 1 to 4+, with 1 representing limited progress and 4+ representing standards and performance typical in advanced industrial economies. The average score is calculated using the transition indicators for large-scale and small-scale privatisation, governance and enterprise restructuring, price liberalisation, trade and foreign exchange system, competition policy, banking reform and interest rate liberalisation, securities markets and non-bank financial institutions, and infrastructure.

very limited benefits, but institutional reforms, including those necessary for further integration with the EU, are critical for private sector development and long-term prosperity.<sup>11</sup>

### 1.3 Summary of the remaining chapters

The analysis begins in Chapter 2 with a detailed look at the business environment across the region. The main focus is on the private sector, which on average now accounts for about 62 per cent of GDP in SEE. Privatisation is well advanced in most countries, and small and medium-sized enterprises (SMEs), which are mostly in private hands, are a vibrant source of growth and employment. However, privatisation has not been a panacea. Often the sale of an enterprise has led to little real restructuring or fresh investment.

The chapter outlines the main barriers to doing business in SEE. Starting up can be costly and time-consuming. For those already in business, there is a range of day-to-day obstacles to overcome. The key constraints include taxation, corruption, lack of access to finance, restrictive labour legislation and the poor quality of regulation. Although the business environment seems

to be improving significantly, the challenge is to build on this advance in future years.

One indirect indicator of the difficulties encountered by legitimate businesses is the size of the informal sector. While no one can be sure how large this is, it seems that about one-third of economic activities in SEE operate outside the law. Informal activities act as a safety valve for many people, helping to alleviate poverty and unemployment. However, they also constitute a significant loss of government revenue, something that all countries in the region can ill afford, and they are a source of unfair competition to legitimate, registered enterprises.

Chapter 3 focuses on financial intermediation and access to domestic sources of finance throughout the region. Internal funds, including retained earnings, are still a major source of finance for enterprises, especially for SMEs, but borrowing from commercial banks is becoming increasingly important. Despite improvements, the level of financial intermediation throughout the region remains small relative to CEB countries. Banks are reluctant to lend on a medium- or long-term basis, especially to SMEs. Enterprises face high interest rates, and

loan applications often take a long time to process. However, public confidence in the sector is returning, and the increasing private involvement in bank ownership is leading to more competition and intermediation.

The chapter also explores the role of other sources of domestic finance. Various SME programmes, supported by IFIs and other outside agencies, have emerged over time in the region, including dedicated micro-finance institutions (specialising in very small loans) and SME credit lines. However, in general, the underdeveloped non-banking financial sector offers a poor alternative to bank financing. Sources of finance such as securities market instruments or lease finance are typically available only in the more advanced countries of the region. SMEs throughout the region are often forced to seek informal sources of finance, including family capital and remittances. Major challenges remain, including developing a proper legal and institutional framework and encouraging banks to respond more positively to lending opportunities.

Chapter 4 examines the role of foreign capital. The integration of SEE into the international capital markets is a recent phenomenon. However, since the late 1990s the region has increased its share of total capital inflows to emerging markets, indicating that increased political and macroeconomic stability, coupled with progress in reforms, are making the region more attractive to investors. FDI is the main type of capital inflow and is closely linked with privatisation proceeds. Most inflows are private in origin, although some of the countries of the western Balkan region remain heavily dependent on official inflows. A geographical and sectoral analysis shows that most FDI comes from EU countries, such as Italy, Germany, Austria and Greece, and is concentrated in the manufacturing sector.

In 2003 net FDI inflows to SEE exceeded US\$ 6 billion, a record year for the region since transition began. As privatisation-related and official inflows to SEE are projected to decrease in the future, the key challenge ahead is to build on this momentum and attract increasing inflows

<sup>11</sup> The argument that initial reforms in transition economies have only a small impact on growth is supported by the econometric evidence of Falcetti et al. (2002).

of foreign private capital, preferably in the form of FDI into new enterprises. Whether the region meets this challenge successfully depends on a number of factors, including political stability, further progress in reforms, and deeper integration with the EU. The creation of a common free-trading area would make the region more attractive for outside investors. While taxation rates are not particularly favourable in the region, labour costs are well below those in CEB countries, adding to the attractiveness for new investment.

Chapter 5 analyses trade both within the SEE region and with other regions. Most countries in SEE trade less than might be expected even though all have made significant progress in implementing trade liberalisation measures. Most are relatively open by world standards, and all except two (Bosnia and Herzegovina, and Serbia and Montenegro) are members of the World Trade Organization (WTO). The main obstacles to trade appear to lie in a range of non-tariff barriers, including the poor level of infrastructure and corruption in customs. Unrecorded trade also appears to be significant, though its actual size is unknown.

Several initiatives are under way to enhance cross-border trading opportunities for enterprises in the region. A series of bilateral free trade agreements within the region have been signed, and many are already under implementation. However, more work is needed in the coming years to ensure that both the spirit and the letter of each agreement are observed, and that the agreements become progressively more compatible with each other. Access to EU markets has been enhanced in recent years, but further measures are required to overcome technical barriers to trade.

Finally, Chapter 6 proposes some practical policy conclusions and initiatives. These include measures to deepen financial intermediation, tackle the informal sector, target improvements to the investment climate and legal environment, and implement proposals to help create a region where trade and investment flows across borders are straightforward and beneficial to all.

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# Enterprise development, privatisation and the business climate

## 2

Although transition and reforms are progressing in most SEE countries, and the regional economy is growing, there is a long way to go to catch up with the EU accession countries of CEB. If this gap is to be bridged in the long term, the private sector in SEE must take the lead role. The state will continue to have an important enabling function, but it cannot by itself be the main driver of growth. Is the private sector ready to meet the challenge? This chapter looks at the structure of the enterprise sector in SEE, the experience of privatisation and the quality of the business environment. It also examines the distinction between formal and informal activities and the influence of the informal sector throughout the region.

The chapter focuses firstly on formal sector activities, providing an overview of the private sector and its relative contribution to GDP in each country. On average, the state still accounts for nearly 40 per cent of GDP in SEE, a higher share than in other transition regions. The role of privatisation is then assessed, including the successes and failures of different methods used and the possibilities for further privatisations.

A favourable business environment can also enhance private sector development. This chapter uses survey data to explore the main obstacles to doing business, and to see how SEE compares with other transition regions in this regard. Ultimately, enterprises that find it too difficult to operate legitimately may choose to circumvent restrictions by evading taxes and other legal requirements. The chapter therefore examines this informal sector: its size, the reasons for its large share of economic activity, and the implications for the rest of the economy. The final section summarises briefly the main conclusions of the chapter.

**Table 2.1**

### Private sector share in GDP, 1995 and 2003

	Private sector share in GDP, 1995 (in per cent)	Private sector share in GDP, 2003 (in per cent)
<b>SEE</b>		
Albania	60	75
Bosnia and Herzegovina	na	50
Bulgaria	45	75
Croatia	45	60
FYR Macedonia	40	60
Moldova	30	50
Romania	40	65
Serbia and Montenegro	na	45
<b>Selected CEB countries</b>		
Czech Republic	70	80
Hungary	60	80
Poland	60	75
Slovak Republic	60	80
Slovenia	45	65

Source: EBRD staff estimates.

### 2.1 Enterprise structure in the formal sector

This section considers official, registered businesses (including individual entrepreneurs) and farms that are subject to taxation and contribute to the official GDP figures. Formal activities may be divided into those provided by the state and those by the private sector. In practice, however, the distinction between the two in SEE can be confusing, and therefore measuring the size of the private sector is neither straightforward nor precise.

The following examples illustrate these measurement difficulties. In the case of a state-owned enterprise that has been leased to a private company, the (net) output should be classified as private. Similarly, the value added of a private

sub-contractor who buys from, and sells to, state-owned enterprises should also be treated as private.<sup>1</sup> A further complication arises in the case of the countries of former Yugoslavia where social ownership – effectively ownership of firms by the management and workforce – was widespread, introducing a further category of output into the picture.

The annual EBRD *Transition Report* provides mid-year estimates of the private sector share in GDP, using as much information as possible from official data and other sources, as well as a certain amount of informed guesswork. The numbers for each country are only rough estimates, rounded to the nearest multiple of five. Table 2.1 shows the 1995 and 2003 figures for each SEE country, with a comparison to selected CEB countries.

<sup>1</sup> These examples are discussed in more detail in EBRD (1994, Box 2.1).

Table 2.2

## Number of enterprises in SEE

	Number of SMEs (including micro enterprises)	Number of micro only enterprises	Number of large enterprises	Number of SMEs per 1,000 inhabitants
<b>SEE</b>				
Albania	56,237	54,145	253	18.1
Bosnia and Herzegovina	30,000	25,600	200	7.0
Bulgaria	224,211	207,643	741	27.6
Croatia	63,135	41,988	426	13.7
FYR Macedonia	27,938	25,985	194	14.0
Moldova	22,138	17,760	2,547	6.1
Romania	612,862	311,260	1,955	27.4
Serbia and Montenegro	66,968	64,002	742	7.8
<b>Selected CEB countries</b>				
Czech Republic	876,990	830,601	1,671	85.1
Hungary	858,981	827,806	1,041	85.9
Poland	3,368,367	3,206,452	6,589	87.0
Slovak Republic	365,783	354,373	160	67.7
Slovenia	26,915	22,285	308	13.5
Europe-19 (2000) (EU member countries and Iceland, Liechtenstein, Norway and Switzerland)	20,415,000	19,040,000	40,000	52.8

Sources: EBRD survey of national authorities and European Commission (2002).

Note: Data for Albania, Croatia, Czech Republic and Hungary are for 2002. Data for Bosnia and Herzegovina, Moldova, Poland, Serbia and Montenegro, Slovak Republic and Slovenia are for 2001. Data for Bulgaria, FYR Macedonia, Romania and Europe-19 are for 2000. In Moldova, large enterprises include those with over 50 employees.

According to these estimates, the private sector share in GDP has risen substantially throughout the region since the mid-1990s, in most cases by at least 20 percentage points. However, SEE still has a lower private sector share than in CEB. The share in SEE has been growing in recent years in two of the countries with the lowest share – Bosnia and Herzegovina and Serbia and Montenegro. This reflects substantial progress in small-scale privatisation, which is more or less complete in most other countries of the region. Nevertheless, as of end-2003 SEE lags a full 15 percentage points behind CEB (62 and 77 per cent respectively) in terms of the share of the private sector in GDP. This suggests an untapped potential for further private sector growth.

### SMEs and large enterprises

Another way of dividing the enterprise sector is between small and medium-sized enterprises (SMEs, including micro-enterprises) and large enterprises.

For the purpose of this analysis, a SME is defined as an enterprise with less than 250 employees. Among SMEs, micro-enterprises are those with less than 10 employees, while “small” enterprises have at least 10 employees, but less than 50. This employment-based definition is consistent with the one used by the EU, which also incorporates other criteria based on annual turnover or balance sheet total.<sup>2</sup> Unfortunately, some SEE countries define

SMEs differently. For example, the authorities in Moldova define “large” enterprises as those with more than 50 employees, most of which are categorised as medium-sized under the EU criterion. The statistics on SMEs should therefore be interpreted with caution.

SMEs play a vital role in all countries of SEE. According to a recent United Nations survey, SMEs account for more than 50 per cent of GDP in several countries of the region, including Albania, Croatia and Romania.<sup>3</sup> SME development is a high priority for all governments in the region, as witnessed by their commitment to, and participation in, the Stability Pact-sponsored Investment Compact for SEE.<sup>4</sup>

Table 2.2 estimates the division of the enterprise sector into SMEs (including micro-enterprises) and large enterprises for each country in SEE and selected countries in CEB (Czech Republic, Hungary, Poland, the Slovak Republic and Slovenia). The most striking result is that the number of SMEs per capita in SEE is well below the level in most CEB countries. Bulgaria and Romania have the highest number in SEE, each with about 27 SMEs per 1,000 inhabitants, but well below the Slovak Republic at 68 per 1,000, and the Czech Republic, Hungary and Poland, each with between 85 and 87 SMEs per 1,000. Interestingly though, the number of SMEs per 1,000 in Slovenia, an EU accession country that was once part of former Yugoslavia, is only 13 – comparable to Croatia, and below not only Bulgaria and Romania but also Albania and FYR Macedonia.

The table also highlights the significant role that micro-enterprises play in most countries in SEE. The proportion of registered SMEs classified as micro-enterprises varies from about 51 per cent in Romania to more than 98 per cent in Albania. The proportion of micro-enterprises in the SME total in CEB countries is typically closer to that in Albania than Romania.

<sup>2</sup> The EU definition of a SME, updated by the European Commission in May 2003, defines a SME as an enterprise with less than 250 employees and either an annual turnover below €50 million or a balance sheet total below €43 million. For further details on the division among micro, small and medium enterprises, see [http://europa.eu.int/comm/enterprise/enterprise\\_policy/sme\\_definition/index\\_en.htm](http://europa.eu.int/comm/enterprise/enterprise_policy/sme_definition/index_en.htm).

<sup>3</sup> See UN/ECE (2003).

<sup>4</sup> The Investment Compact has sponsored a number of policy analyses of investment climate issues in the region. See, for example, the Enterprise Performance and Policy Assessments (EPPAs) produced jointly by the OECD and EBRD for all countries in the region.



Table 2.3 outlines the sectoral composition of SMEs. All SEE countries have a high percentage of SMEs registered in trade (more than 50 per cent for Albania, Bulgaria and Romania) whereas, in most cases, only a small percentage of SMEs are active in construction and manufacturing.

## 2.2 Privatisation

All governments in the SEE region have stated their commitment to privatisation and the principles of the market economy. Privatisation has been a significant revenue earner and a major channel for foreign direct investment (FDI), which in turn is a source of benefits not only to the receiving firm but also to the wider economy.<sup>5</sup> However, the level of commitment to privatisation has varied across countries. As a result, progress in SEE has generally been slower than in CEB and the process has some way to go in parts of the region.

One way of comparing progress in privatisation across countries and time is through the EBRD transition indicators for small and large-scale privatisation. As explained in Chapter 1, the scale for all indicators is 1 to 4+, where 1 indicates little or no progress in the relevant transition criterion, while 4+ would be equivalent to the standards and performance of an advanced market economy. In the case of small-scale privatisation, a score of 4+ would mean that the country in question has removed all state ownership from small enterprises and has an effective market for buying and selling land. For large-scale privatisation, achieving the highest score requires more than 75 per cent of large enterprise assets to be in private ownership, with effective corporate governance.

Charts 2.1 and 2.2 show the progress over time, relative to CEB and the CIS, that SEE countries have made in small and large-scale privatisation. Some countries were late in starting the transition process, so the region as a whole (on a simple average basis) lagged behind even the CIS in the mid-1990s on large-scale privatisation. However, by 2000 SEE had overtaken the CIS and is continuing to catch up with CEB – as shown in the upgrades for Croatia and Serbia and Montenegro (for large-scale

**Table 2.3**

### Structure of SMEs by sector, 2001 (in per cent)

	Trade	Services	Construction and manufacturing	Other activities
<b>SEE</b>				
Albania	52.1	17.8	12.5	17.6
Bosnia and Herzegovina	45.0	12.0	27.0	16.0
Bulgaria	50.8	28.9	18.0	2.3
Croatia	35.0	7.0	28.0	30.0
Moldova	48.6	28.5	19.0	3.9
Romania	63.0	16.0	14.9	6.1
Serbia and Montenegro	47.5	5.3	25.8	21.4
<b>Selected CEB countries</b>				
Czech Republic	35.0	19.9	23.9	21.2
Hungary	26.0	50.2	19.9	3.9
Poland	35.8	25.6	34.2	4.4
Slovak Republic	43.9	29.8	20.6	5.7

Source: UN/ECE (2003).

Note: Data for Bulgaria are for 2000. Data for FYR Macedonia were not available.

privatisation) in the 2003 EBRD *Transition Report*. Only Bulgaria has yet achieved a 4+ score on the EBRD scale for large-scale privatisation. Bosnia and Herzegovina and Serbia and Montenegro, which started their transition later than the other countries, have made the least progress overall.

Privatisation may lead not only to restructuring, and fresh capital and management skills, but it also generates substantial government revenues, which are an important source of financing in the transition economies of SEE. As Table 2.4 shows, some countries have had a windfall from privatisation sales in recent years, notably FYR Macedonia in 2001 due to the sale of a majority stake in the fixed-line telecommunications company Maktel (see also Chapter 4). One country of special interest is Serbia and Montenegro, where revenues increased dramatically between 2000 and 2001, trebled between 2001 and 2002, and are estimated to have more than doubled again in 2003 relative to the previous year. Other countries in the region, however, show a decline in privatisation revenues in 2003, possibly associated with the general global economic slowdown as well as a dwindling stock of assets for sale.

Chapter 4 looks further at the role of privatisation as a source of FDI.

## Privatisation methods

The benefits of privatisation depend not only on how many enterprises are sold off, but also on the method used to privatise them. Enterprise development may be held back by an inappropriate choice of privatisation method. After more than 10 years of transition, there is a lot of empirical evidence on this issue. Privatisation is indeed linked strongly with enterprise restructuring, at least in non-CIS countries; on average, privatisation to outside buyers is associated with 50 per cent more restructuring than is privatisation to insiders (people already in the firm at the time of sale).<sup>6</sup> The problem with insider privatisation is that it often leaves in charge parties with vested interests, which have little incentive to implement changes. This reduces the potential interest of outside investors.<sup>7</sup> For those countries that still have significant state-owned enterprises to sell off, these are important findings that may guide future sales.

<sup>5</sup> The benefits of FDI are brought out in EBRD (2003, Chapter 5), Hunya (2000), Meyer (1998) and Bevan and Estrin (2000). See also Chapter 4 below.

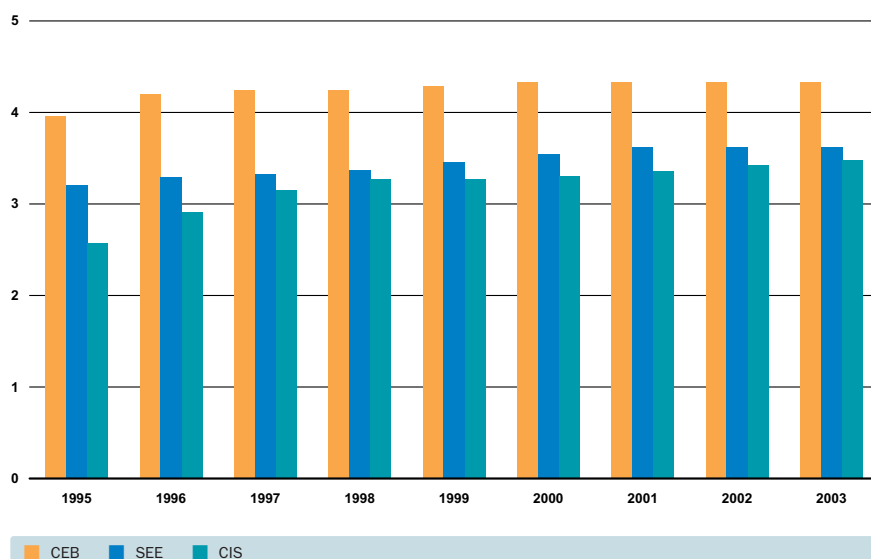
<sup>6</sup> See Djankov and Murrell (2002).

<sup>7</sup> See Zinnes et al. (2001).

Chart 2.1

## Progress in small-scale privatisation, 1995-2003

EBRD transition indicator



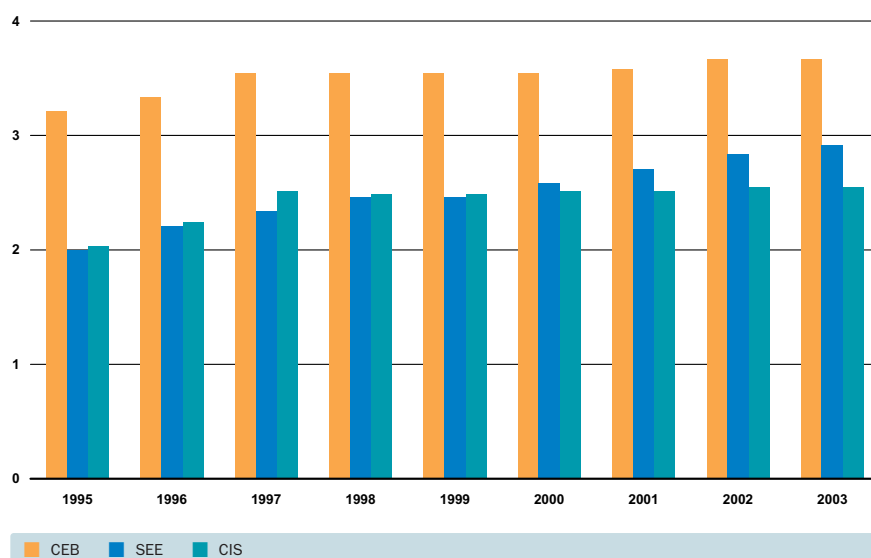
Source: EBRD.

Note: The EBRD transition indicator ranges from 1 to 4+, with 1 representing little progress towards small-scale privatisation and 4+ indicating no state ownership of small enterprises and effective tradability of land.

Chart 2.2

## Progress in large-scale privatisation, 1995-2003

EBRD transition indicator



Source: EBRD.

Note: The EBRD transition indicator ranges from 1 to 4+, with 1 representing little progress towards large-scale privatisation and 4+ indicating more than 75 per cent of enterprise assets in private ownership with effective corporate governance.

Countries in SEE have used a variety of privatisation methods, including direct sales, vouchers, management/employee buy-outs, and occasionally other means. The chosen method often depends on the size of the enterprise being sold, with auctions common for small enterprises

and tenders for direct sales more likely for larger companies.

Table 2.5 gives a summary of the primary and secondary methods used over the transition period in each SEE country and in selected countries in CEB. It shows that

Bulgaria is the only SEE country using direct sales as the primary method (in common with Hungary, Poland and the Slovak Republic). Although the direct sale procedure is often lengthy and complex, it usually results in the highest privatisation revenues and interest of strategic investors. Bulgaria has attracted fresh outside investment through direct sales as well as a significant amount of government revenue relative to GDP. In contrast, mass privatisation through the issuing of vouchers to citizens, as favoured by Bosnia and Herzegovina and Moldova (and also Montenegro), does not typically generate either significant government revenue or investment; instead, it leads only to the redistribution of property and often poor quality governance.<sup>8</sup>

Albania, Croatia, FYR Macedonia and Romania have followed the Slovenian model of management-employee buy-outs (MEBOs) – insider privatisation – as their primary method, with less use of vouchers or direct sales. It is often the case that such privatised firms turn out to be more profitable than those that remain in state (or socially owned) hands. However, this does not necessarily mean that privatisation has been responsible for the increase in profitability; it may simply be that buyers were attracted to those enterprises that were already more profitable or likely to be so. For example, an IMF study of privatisation in FYR Macedonia during the mid-1990s concluded that, once this consideration (known as “selection bias”) was taken into account, there was little evidence to support the argument that privatisation led to greater profitability.<sup>9</sup> This study highlights the importance of attracting fresh external capital and of implementing appropriate legislation, especially in the area of creditor and shareholder rights.

In summary, the relatively slow start to privatisation in SEE, and the way in which it has been done, partly explain the often sluggish performance of the private sector – but only partly. There is a limit to which privatisation can boost the overall development of the private sector, even when the process is open and transparent and leads to new investment, skills and processes. Several countries in SEE, as in CEB, are approaching that limit, since privatisation is either close to completion or, with the

<sup>8</sup> See Hunya (2000).

<sup>9</sup> See IMF (2000, Annex III).



Table 2.4

**Privatisation revenues, 2000-03 (percentage of GDP)**

	Albania	Bosnia and Herzegovina	Bulgaria	Croatia	FYR Macedonia	Moldova	Romania	Serbia and Montenegro
2000	1.7	1.3	1.3	2.1	1.1	6.4	0.6	0.0
2001	2.1	0.8	0.6	3.3	10.6	0.4	0.6	0.0
2002	0.1	0.1	0.9	2.3	0.7	0.7	0.1	2.6
2003 (estimate)	0.2	0.1	1.1	1.7	0.1	0.3	0.2	6.6

Sources: IMF country reports and EBRD database.

Table 2.5

**Privatisation methods in SEE**

	Management employee buy-outs (MEBOs)	Vouchers	Direct sales
<b>SEE</b>			
Albania	primary method	secondary method	-
Bosnia and Herzegovina	-	primary method	secondary method
Bulgaria	-	secondary method	primary method
Croatia	primary method	secondary method	-
FYR Macedonia	primary method	-	secondary method
Moldova	-	primary method	secondary method
Romania	primary method	-	secondary method
Serbia and Montenegro	-	primary method	secondary method
<b>Selected CEB countries</b>			
Czech Republic	-	primary method	secondary method
Hungary	secondary method	-	primary method
Slovak Republic	-	secondary method	primary method
Poland	secondary method	-	primary method
Slovenia	primary method	secondary method	-

Source: EBRD *Transition Report 2003*.

Note: The primary (secondary) methods of privatisation are those methods that have been used most (second most) frequently since the start of transition.

exception of public utilities, those assets which are still to be sold are likely to have a minor effect on medium- or long-term economic growth. For the region as a whole, future private sector development will have to come mainly from new businesses and from the restructuring and development of existing privately owned enterprises.

**2.3 Obstacles to formal private sector development**

Doing business in SEE is often difficult. Several surveys of enterprises in the region, either within individual countries or across a group of countries, reveal a range of problems, including lack of access to finance, inadequate infrastructure, stifling bureaucracy and onerous taxation.<sup>10</sup> This section draws on three such surveys to

assess where SEE stands in terms of ease of setting up a business and the quality of the enterprise environment.

**World Bank survey: "Doing Business in 2004"**

This comprehensive analysis of regulation and the obstacles to starting and operating a business in 130 countries around the world also contains an estimate of the costs of registering an enterprise and the time it takes to do so. The results show that setting up a business can be a time-consuming and expensive procedure. In SEE, the number of days needed to register a business formally ranges from 27 days in Romania to 59 days in Bosnia and Herzegovina. Interestingly, however, it takes even longer to register in the Czech and Slovak Republics (88 and 98 days respectively) and Hungary (65 days) than it does in any SEE country. Within SEE, there is a wide variation in the cost to register a business – ranging from US\$ 121 in Moldova to US\$ 897 in Albania – although there is no clear reason for this variance.

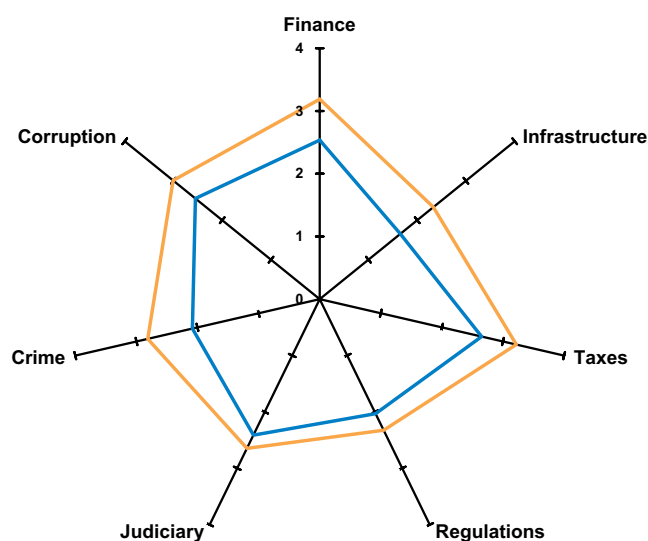
**EBRD-World Bank survey: Business Environment and Enterprise Performance Survey (BEEPS)**

The BEEPS contains the most comprehensive review of the business environment for active enterprises in transition countries. Conducted in 1999 and 2002, it asked entrepreneurs to evaluate economic governance and state institutions and to assess the extent to which the business environment created obstacles to the operation and growth of

<sup>10</sup> The Enterprise Policy Performance Assessments (EPPAs) carried out jointly by the OECD and the EBRD for each country in the region also contain the results of focus group interviews with local business people, where the problems mentioned in the text (above) are frequently highlighted.

Chart 2.3

## Business environment in SEE, 1999 and 2002



— 1999 — 2002

Source: Business Environment and Enterprise Performance Survey (BEEPS), 1999 and 2002.

Note: The score along each dimension is the simple average across all firms in the sample in SEE. The values range from 1 to 4, with 1 indicating no obstacles to business growth and operations, and 4 indicating major obstacles. Data for 1999 exclude Serbia and Montenegro.

investment climate to a numerical scale.

Firms were asked to assess how problematic various factors were for the operation and growth of their business on a scale of 1 to 4. The lower the score, the better the business environment – that is, interviewees who regarded an obstacle as minor or insignificant would give it a score of 1, while a score of 4 indicated a major impediment to doing business.

Chart 2.3 compares the average SEE results in 2002 with those from the 1999 BEEPS. The business environment appears to have improved significantly across almost every category between 1999 and 2002. Areas that seem to show the largest improvement are infrastructure, access to finance and crime.

The two rounds of the BEEPS are not directly comparable however, for two reasons. Firstly, the sample of interviewed enterprises was different, and secondly, the formulation of the questionnaire was slightly modified. In particular, the questions relating to infrastructure were changed in a way that may have led to an unrealistically large apparent improvement in this category. It is also possible that other factors, such as the position of each country in the business cycle, may have strongly influenced people's perceptions of the business environment.<sup>11</sup>

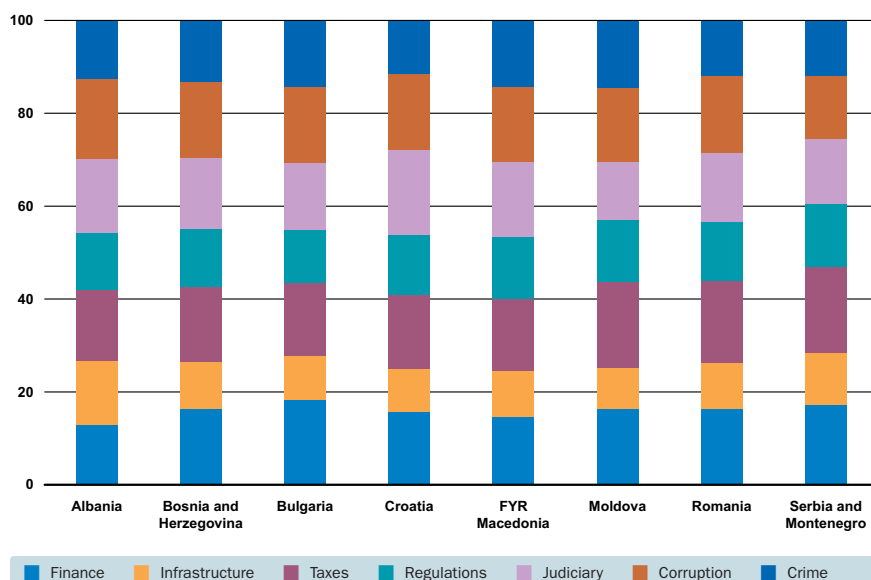
Specific barriers to doing business may be more important in some countries than others. Chart 2.4 shows that taxation, corruption, and finance are perceived as the three major obstacles to investment across most countries, although their relative ranking in importance differs among countries. The poor functioning of the judiciary is also considered a serious impediment to investment especially in Albania, Bosnia and Herzegovina, Croatia and FYR Macedonia.

Taxation is a particular concern for enterprises, as it may involve administrative bureaucracy as well as high tax rates in some countries. It is seen as the major barrier to investment in FYR Macedonia, Moldova and Serbia and Montenegro, and ranks among the top three obstacles in other countries of the region. Corruption is also one of the bigger deterrents for

Chart 2.4

## Barriers to investments in SEE, 2002

Per cent



Source: Business Environment and Enterprise Performance Survey (BEEPS), 2002.

Note: The chart shows the relative importance of each obstacle for a given country.

their businesses. In particular, the survey asked firms to assess how the functioning of the state, physical infrastructure and financial institutions affected their operations. Seven broad areas, directly or indirectly related to the functioning of the state and public administration, were

assessed: finance, infrastructure, taxation, business regulation, the judiciary, crime, and corruption.

For many questions in the BEEPS, interviewees were asked to convert their subjective impressions of aspects of the

<sup>11</sup> This concern has been subjected to a number of consistency checks in Fries et al. (2003). They conclude that, for most countries (including all those in SEE), any perception bias is minor and would not alter significantly the results.

## Box 2.1

## Measuring the informal economy

Informal economic activity is difficult to measure, as there is a lack of hard data. There are several indirect signs that the informal sector in SEE might be larger than in CEB, such as the much smaller ratio of SMEs to population and the high bureaucratic and bribery costs of doing business. However, these indicators by themselves do not show how big the sector actually is.

There are different ways of estimating the size of the informal economy.<sup>1</sup> One direct way would be to carry out a survey of individuals and enterprises. If randomness is observed in the sample design and anonymity is guaranteed to respondents, then such an approach might yield reliable estimates of the extent of informal activity throughout the whole economy. In practice, however, such surveys are expensive and difficult to conduct. Even if anonymity is assured, firms may still be reluctant to reveal the full extent of their unrecorded activities.

There are also indirect means of measurement; for example, looking at the discrepancy between national income and expenditure statistics. However, some national statistical authorities already make an effort to include an estimate of informal activity in recorded GDP, and therefore any calculation using this method may be a significant underestimate.<sup>2</sup> Another method is to estimate the demand for currency and attribute any “unexplained” increase in demand – that is, an increase not explained by other factors such as per capita income, tax rates and interest rates on savings – to a rise in the informal economy. One assumption underlying this approach is that all transactions in the informal economy are carried out using cash, something that is not always the case. A third indirect method is to use electricity consumption as a proxy for GDP, on the

assumption that it reflects overall economic activity (formal and informal). However, this method is also questionable as it implicitly ignores technical progress and pricing changes that affect the use of electricity.

Two other approaches are worth mentioning. One uses “factor analysis” on a number of possible causes and indicators to estimate the size of the informal economy.<sup>3</sup> Relevant indicators may include, for example, changes in cash holdings or in labour participation rates. This method leads to estimates of the informal sector that are broadly similar across SEE countries, at around one-third of GDP. The same method estimates the share of informal activities in the total at between one-fifth and one-quarter of GDP in CEB countries, and about 18 per cent of GDP on average in the OECD. Alternatively, actual tax revenue can be compared with what the level of revenue should be if all enterprises paid the correct amount of tax.<sup>4</sup> This approach starts from final household consumption (as reported in the national accounts), from which an estimate of true household income is derived. This is then set against an estimate of the average overall statutory tax rate applicable to households to yield an estimate of undeclared (informal) activity. This method gives a much wider range of estimates in SEE than other methods do, ranging from 19 per cent of GDP in Croatia to 51 per cent in Albania (Moldova is not included).

1 This discussion draws on the useful survey of Schneider and Enste (2000).

2 The distinction between *unrecorded* and *unreported* economic activity is stressed by Dean (2002).

3 This method has been popularised by Schneider (2002a,b).

4 This approach is introduced and explained in Christie and Holzner (2003).

businesses in all countries. Problems associated with access to finance are perceived as particularly severe (relative to other barriers) in Bulgaria and Bosnia and Herzegovina, and rank second highest in Moldova and Serbia and Montenegro.

### Transparency International: Corruption Perceptions Index

The problem of corruption in SEE is highlighted particularly by the 2003 annual report from Transparency International.<sup>12</sup> This index is drawn from surveys of the perceptions of corruption among business people, academics and risk analysts. In the worldwide rankings, a number of SEE countries score poorly, with several considered among the most corrupt in the sample of countries. The country rankings range from the best SEE performer, Bulgaria, in 54th place (out of 133 countries) to FYR Macedonia and Serbia and Montenegro in equal 106th place.

This evidence suggests that corruption is seen as a major problem throughout the region, and must be tackled urgently. Most

SEE countries have adopted anti-corruption programmes in recent years. However, a comprehensive study of anti-corruption measures in transition countries, also using evidence from the BEEPS, has concluded that omnibus programmes have had little or no effect so far on the level of administrative corruption or state capture.<sup>13</sup> Nevertheless, the same study has shown that new laws aimed directly at tackling administrative corruption have had some positive results. Anti-corruption programmes are important but may take quite some time to work, even with consistent and vigorous implementation.

### 2.4 Informal sector

In virtually every economy in the world, some individuals and enterprises operate outside the law by failing to register their businesses or to obtain the necessary licences and permits. A true picture of the enterprise sector must take these “informal” activities into account.<sup>14</sup> This is especially important in SEE, where informal activities play a key role as a source of growth, employment and poverty alleviation.

It should also be noted that the world of business – in SEE or anywhere else – is not divided neatly into firms that are always within the law and those that are always outside it. In practice, there is much anecdotal evidence that many firms keep two sets of accounts – one that they show to the tax authorities and the other, possibly unwritten, which includes payments and revenues that are not recorded officially. This complicates the already difficult task of trying to measure the size of the informal economy (see Box 2.1).

There is no clear guidance on where to draw the line between formal and informal activities. Different definitions of the informal sector have been proposed.<sup>15</sup> A broad definition would encompass both legal and illegal activities – the former includes activities that would be legal, if they were reported to the authorities, with the appropriate taxes paid and in compliance with relevant rules and regulations; the latter includes smuggling of goods, trafficking of people, fraud, prostitution and other crimes. In both types of activity, barter may be used rather than monetary transactions.

<sup>12</sup> See Transparency International (2003).

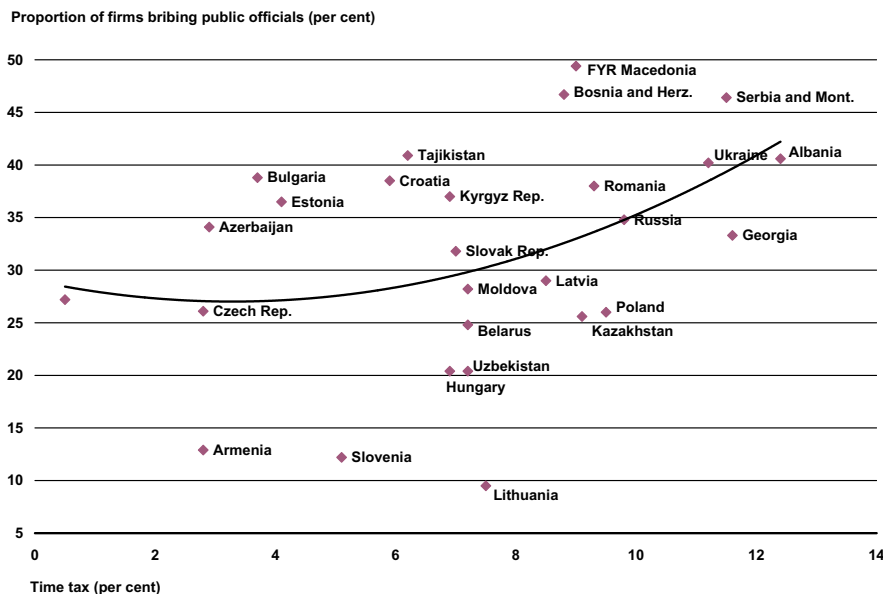
<sup>13</sup> See Steves and Rouso (2003). “State capture” refers to the ability of a narrow group of vested interests to manipulate government policy-making.

<sup>14</sup> Other terms in common usage include “shadow economy”, “grey economy” and “black economy”.

<sup>15</sup> For a recent survey, see Schneider and Enste (2000).

Chart 2.5

### Regulatory “time tax” and proportion of firms that are perceived to pay bribes to public officials, by country



Source: Business Environment and Enterprise Performance Survey (BEEPS), 2002.

Note: Time tax refers to the proportion of senior management time spent on dealing with public officials. No data were available for Turkmenistan.

The distinction between legal and illegal activities is particularly important in SEE. Organised crime is recognised by all governments in the region as a serious problem that needs to be tackled energetically.<sup>16</sup> Strong efforts are being made throughout the region to fight organised crime, although the level of success so far has been variable. In contrast, many local people take a more relaxed view of legal but unrecorded activities, since they often lead to jobs for those who would otherwise be unemployed, providing a social welfare lifeline that the state is unable to afford.

#### Reasons for informal sector activity

Why do some firms and entrepreneurs choose to evade taxes and other legal requirements of doing business? Cost-benefit analysis may help to explain this. Doing business in SEE is difficult and costly, in part because of the associated bureaucracy and regulations. The benefits

of ignoring these requirements are obvious and, in many cases, substantial. The costs come mostly from potential fines and other penalties imposed on those who do not obey the law. While these can be large and punitive, enforcement is typically lax and many enterprises feel – with some justification – that they can get away with not registering.

The BEEPS gives further insights into the costs of dealing with bureaucracy and corruption in SEE. Chart 2.5<sup>17</sup> shows, for all countries in the BEEPS, the proportion of firms that pay bribes frequently to public officials for licences, permits and inspection certificates, as well as the average “time tax” (the proportion of senior management time spent on dealing with public officials). Among the 26 transition countries in the BEEPS, the problem of bribing public officials is worst in Bosnia and Herzegovina, FYR Macedonia and Serbia and Montenegro

– all in SEE. Albania, Bulgaria, Croatia and Romania are also near the top of this category, suggesting that bribery is prevalent throughout the region, while Albania has the highest “time tax” of all 26 countries. The incentives to bypass these problems and operate informally, even if that also involves paying bribes, are correspondingly large.

Finally, the perceived lack of access to finance, which was cited by many BEEPS respondents as one of the biggest obstacles to doing business, is another factor that affects the incentive to register. All applicants for loans from banks have to be registered businesses. If firms think that applying for loans is a fruitless task, then this removes one incentive to be registered.

#### Effects on the formal economy

Should governments in SEE be concerned about the size of the informal economy? It is true that a vigorous informal sector can be an indication of entrepreneurial spirit and can provide a social safety net for those who work within it. Some studies have even argued that a growing informal economy is positively associated with GDP growth; others, however, have reached the opposite conclusion.<sup>18</sup> Although many policy makers do not regard bringing the informal sector into the official net as a priority, the problem is moving up the agenda.<sup>19</sup>

Increasingly, many would argue that governments in SEE should not be complacent and that the disadvantages of a large informal sector, in terms of lost revenue to the exchequer, should be addressed urgently throughout the region. Not only are the tax revenue losses substantial, but also the problem appears to be closely associated with corruption which, as noted earlier, is a serious barrier to private sector development. In addition, the informal sector affects the competitiveness of formal businesses; since unregistered firms do not pay taxes, they automatically gain unfair advantage over formal sector

<sup>16</sup> The issue of organised crime in south-eastern Europe, and especially in the western Balkans, was addressed at a major conference in London, hosted by the UK government, in November 2002. A recent information paper (IP/03/1608) by the European Commission, issued on 26 November 2003, noted that progress has been made by the western Balkans countries since the London conference but also that there was room for improvement in implementing measures to fight organised crime and illegal cross-border trade. See [http://europa.eu.int/comm/external\\_relations/see/news/ip03\\_1608.htm](http://europa.eu.int/comm/external_relations/see/news/ip03_1608.htm) for more details on the financial and technical support provided by the EU in these areas.

<sup>17</sup> This chart is presented in Fries et al. (2003).

<sup>18</sup> Recent contributions to the debate include Gligorov et al. (2003), Kuchta-Helbling (2002), Ott (2003) and Lacko (2003).

<sup>19</sup> For example, the Albanian government has recently asked the OECD to carry out a study of the informal sector in Albania and to come up with policy recommendations for how to reduce its size.

businesses. In the case of Albania, a 1999 survey of legal enterprises showed that competition from the informal sector was seen as the biggest obstacle that they faced in doing business, outweighing even access to finance or taxes.<sup>20</sup>

## 2.5 Conclusions

This chapter has shown that the private sector in SEE has advanced steadily to the point where it now accounts for more than 60 per cent of GDP. The experience of other transition regions suggests that this share will increase further over the short to medium term. SME development and privatisation are both helping to drive the process. The number of SMEs in the region is significant, contributing substantially to economic growth. However, the registration of SMEs relative to size of population lags behind advanced EU accession countries. In most cases, small-scale privatisation is virtually complete, although a couple of countries are still catching up in this area. But the experience of privatisation has been mixed. The insider privatisation method favoured by some countries has led to little real restructuring or investment.

Different surveys on obstacles to doing business across the region have reached the same broad conclusions. Starting a business is often time-consuming and, in a few countries, very expensive. Those firms already in operation face a range of hurdles, of which the most serious are usually taxation, corruption and lack of access to finance. Many SEE countries score poorly on Transparency International's corruption index and a sustained effort to combat corruption is needed.

Finally, the chapter noted that informal sector activities in SEE are large, possibly accounting for about a third of GDP on average, and even more in some countries. Although such activities are a lifeline for many, they represent a significant loss of revenue to the government and unfair competition for those enterprises that operate legitimately. Future private sector development, therefore, should go hand-in-hand with a lower share of the informal sector.

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<sup>20</sup> See Muent et al. (2001).





# Access to domestic finance

# 3

Access to finance is essential for private sector development. In all economies, new and expanding firms are likely to need outside funding to pursue their development plans at some stage. Internal funds, including retained earnings, are often not sufficient for this purpose.<sup>1</sup> This chapter analyses the principal sources of domestic finance available to enterprises in SEE, the extent to which the region's banking sector is meeting the needs of local businesses, and the alternatives to banks as sources of funds.<sup>2</sup>

The chapter begins by looking at the most important sources of finance, as reported by respondents to the Business Environment and Enterprise Performance Survey (BEEPS – see Chapter 2). For small and medium-sized enterprises (SMEs) in all SEE countries except Croatia, internal funds are the main source of new investment rather than borrowing from the banking sector. The next section analyses the reasons for this, identifying common negative factors across the region, such as the lack of real competition in the banking sector, cautious lending policies, weak creditor protection and a legacy of mistrust in banks among the public (reflected in the low level of deposits).

If the banking sector cannot fully meet the needs of enterprises in SEE, other sources must be found. The chapter goes on to examine the alternatives, including micro-finance institutions, credit lines for SMEs, government-sponsored programmes (including credit guarantee schemes), equity markets (although these are in their infancy in the region) and fixed income markets. Finally, the chapter lists the conclusions reached on domestic finance.

## 3.1 Sources of finance for enterprises

When an enterprise wants to finance either new investment or working capital, there are a number of options. One is to use internal sources. Alternatively, an enterprise

Chart 3.1a

### Sources of financing for small and medium-sized enterprises, 2002

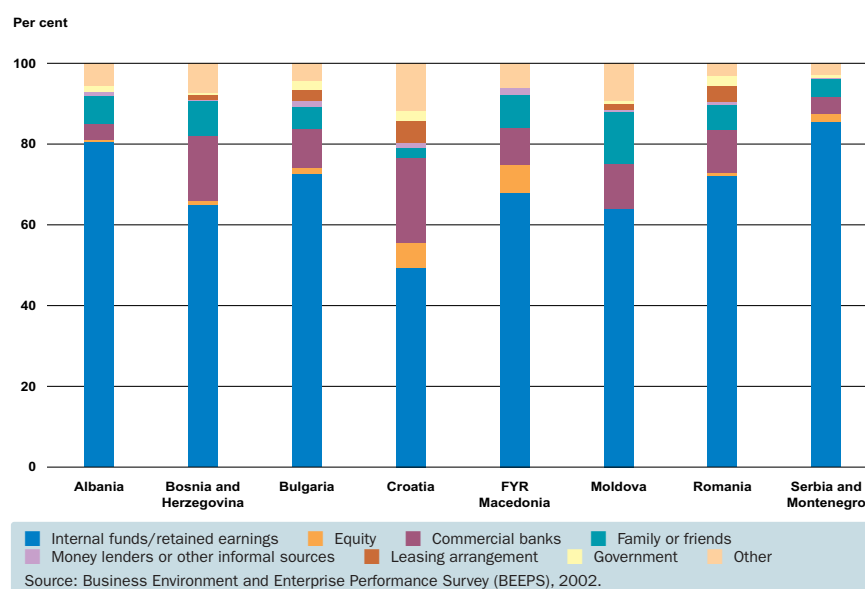
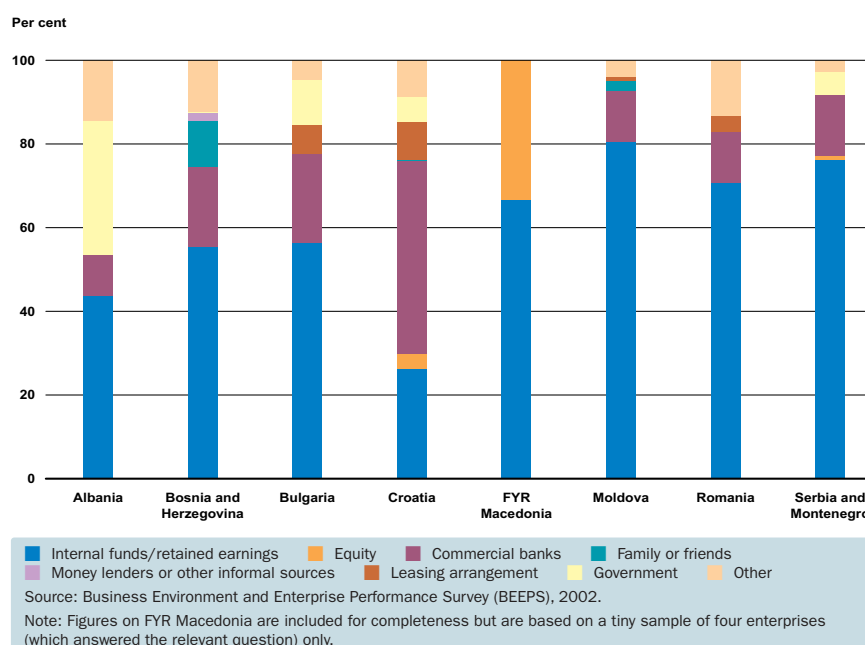


Chart 3.1b

### Sources of financing for large enterprises, 2002



<sup>1</sup> Using firm-level data for 36 countries, Love and Zicchino (2002) show that in countries with more developed financial markets, firms' investment decisions depend less on the availability of internal funds compared with countries with less developed financial markets.

<sup>2</sup> For an earlier overview of financial sector development in SEE, see Pissarides (2001).

## Box 3.1

## Remittances as a source of finance

Many citizens of SEE countries live abroad. The conflicts during the 1990s saw a large exodus of people, in particular from some of the countries of former Yugoslavia and from Albania. As a result, remittances from these migrants back to families and friends at home have soared. Most of these funds go towards the purchase of consumer goods and help to finance the large trade deficits identified in Chapter 1, but increasing attention is being paid to the development role of remittances. Research has shown that these inflows can ease the transition to a market economy – for example, by lowering the rate of unemployment that would otherwise prevail in the country that migrant workers had left, and by allowing policy-makers to pursue a more rapid course of transition.<sup>1</sup> Furthermore, remittances can help revive a spirit of entrepreneurship, which was often discouraged or even suppressed under previous governments.

Data from the IMF Balance of Payments yearbook for 2001 show that, among all transition countries for which data are available, the top four in terms of remittances as a percentage of GDP – Bosnia and Herzegovina, Albania, Moldova, and Serbia and Montenegro – are all in SEE. These four are among the top 20

in the world in terms of remittances per GDP.<sup>2</sup> Croatia and FYR Macedonia also receive significant remittances; in the latter's case, the official IMF figure is thought to be a significant underestimate. Across transition economies generally, high remittances tend to be accompanied by low levels of FDI and vice versa; on a year-on-year basis, remittances are a more stable and reliable source of foreign exchange inflows than FDI.<sup>3</sup>

Remittances are likely to remain an important source of foreign currency for most countries of the region for the foreseeable future. However, to optimise their developmental impact, more needs to be done to encourage migrant workers to provide them through formal, rather than informal, channels. Not only would this more reliably reflect how much money is actually being provided, but it would help to strengthen the local banking sector and financial intermediation more generally.

<sup>1</sup> See Mançellari et al. (1996) and Papapanagos and Sanfey (2003).

<sup>2</sup> See World Bank (2003, Figure 7.4). Bosnia and Herzegovina is omitted from the World Bank's chart but, on IMF estimates, should be included.

<sup>3</sup> See Pissarides et al. (2004).

were asked to list the proportion of their working capital and new investment coming from different sources of finance, both internal and external.<sup>3</sup> Charts 3.1a and 3.1b show the results for SMEs and large enterprises respectively.

## Internal funds

The charts show that in all countries except Croatia internal funds are by far the main source of financing for new investments, especially for SMEs. Across all enterprises, they account on average for over two-thirds of funds for new investments, ranging from 45 per cent in Croatia to 84 per cent in Serbia and Montenegro. Even for large enterprises, they are more important than all other sources added together, except in Croatia and Albania (the government being a significant source of funds in the latter). For SMEs the reliance on internal funds is even greater, ranging from 50 per cent in Croatia to 86 per cent in Serbia and Monte-

negro. While lack of access to external funds is common for SMEs everywhere, including those in the most advanced Western countries, the extent to which those in SEE must rely on their own resources for new investment is quite striking.

## Borrowing from commercial banks

Charts 3.1a and 3.1b also show that borrowing by enterprises from commercial banks (including domestic and foreign banks) covers a relatively small percentage of financing needs for new investments, although there is wide variation across the region. In some of the more advanced countries, such as Bulgaria and Croatia, commercial banks are playing an important role, especially for large enterprises. In Croatia they provide about 46 per cent of funds for new investments for large enterprises and 21 per cent for SMEs. This contrasts with Albania, for example, where the corresponding figures are 10 per

cent and 4 per cent. In all countries bank lending seems more accessible to firms that are based in cities or large towns, compared with those in rural areas. This is partly because, under the old socialist system, only the savings bank in each country had a nationwide branch network.

## Other sources

Lease finance is available to a small but significant extent in Bulgaria, Croatia and Romania.<sup>4</sup> As with bank finance, access to lease arrangements for large enterprises is higher than that for SMEs. For large enterprises, leasing accounts for about 9 per cent of funding for new investment in Croatia, 7 per cent in Bulgaria and 4 per cent in Romania, while for SMEs it accounts for 5 per cent, 3 per cent and 4 per cent respectively. In the other SEE countries, leasing plays an insignificant or non-existent role as a source of finance for all enterprises. In several cases, the whole legal framework for leasing needs to be redesigned – for example, in Bosnia and Herzegovina, where there is no specific law regulating leasing agreements, even though some leasing companies do operate there.<sup>5</sup>

Equity financing is a growing source of external capital in SEE although it still plays a minor role overall, especially for SMEs. In the SEE region there are several equity funds that are operating fully, mainly concentrated in Bulgaria and Romania. In Croatia, while many regional funds operate, there is only one SME-targeted equity fund.<sup>6</sup> In the less advanced countries of the region, the share of equity capital in financing is small at around 1 per cent or less. The role of stock markets is discussed further in Section 3.3 below.

Loans from family and friends also play an important part, especially in countries that benefit from large remittance flows (see Box 3.1). Many remittances flow through informal channels because of the lack of trust in, and high charges of, banks in the region. This source of finance is particularly important for micro and small businesses.

<sup>3</sup> This analysis excludes enterprises that reported no access to any source of finance.

<sup>4</sup> Lease finance is a type of entrepreneurial activity aimed at the investment of temporarily free resources or raised funds when the lessor under the financial lease (leasing) agreement undertakes to acquire property specified by the agreement from a particular vendor and give such property to the lessee for temporary use for business purposes, while charging payment for this service.

<sup>5</sup> In addition, the Convention for International Financial Leasing has not been signed (see membership at <http://www.unidroit.org/english/presentation/main.htm#NR3>).

<sup>6</sup> SEAF – Small Enterprise Assistance Fund, established with assistance from USAID.



### 3.2. Banking sector reform and development

Reforming the banking sector and other non-banking financial institutions is difficult and time-consuming, and several countries are still in the early stages of this process. The two EBRD transition indicators for bank and non-banking financial institution reform are shown in Table 3.1.<sup>7</sup> Only Croatia has achieved a score of 4– for banking sector reform, which puts it ahead of several CEB countries. Most countries score much lower, mainly because the amount of lending to the private enterprise sector is still relatively small. The non-banking financial sector, including stock markets, is underdeveloped in all SEE countries, although less so in Croatia and Bulgaria; the corresponding transition indicator in the table is therefore typically either 2 or 2–. The rest of this section focuses on the banking sector only while other sources of finance are addressed in Section 3.3.

#### Size and number of banks

Table 3.2 presents an overview of banking sector indicators in each country at the end of 2002. The banking sector in SEE countries is small, compared with the equivalent in CEB countries, and even more so relative to the EU. For example, in SEE the weighted average of banking assets to GDP is about 47 per cent, compared with 71 per cent in CEB and 245 per cent in the eurozone. Only Croatia (at 99 per cent) compares favourably with the CEB countries.

There is no shortage of banks in SEE – arguably too many given the size of the market. This is particularly true for countries of former Yugoslavia, where a more relaxed policy on entry to the market was in place in the early years of transition. At the end of 2002 the ratio of commercial banks per 100,000 people in SEE was 0.45 (0.30 in CEB), ranging from 0.14 in Romania to 1.00 or over in Bosnia and Herzegovina, Croatia and FYR Macedonia.

However, many of these banks are small with limited country coverage. Table 3.2 shows that the sector is often highly concentrated, even in countries with many banks. The five largest banks in each country except Serbia and Montenegro accounted for more than 50 per cent of the total banking assets at the end of 2002, and up to 86 per cent in Albania.

Table 3.1

#### Financial sector reform indicators, 2003

	Banking sector reform indicator	Non-banking financial sector reform indicator
Albania	2+	2-
Bosnia and Herzegovina	2+	2-
Bulgaria	3+	2+
Croatia	4-	3-
FYR Macedonia	3	2-
Moldova	2+	2
Romania	3-	2
Serbia and Montenegro	2+	2
SEE	2.75	2.00
CEB	3.43	3.05
CIS	2.06	1.85

Source: EBRD.

Note: The EBRD transition indicator ranges from 1 to 4+, with 1 representing little progress in financial sector reform. For banking sector reform, 4+ represents full convergence of banking laws and regulations with BIS standards and a full set of banking services. For non-banking reform, 4+ represents full convergence of securities laws and regulations with IOSCO standards, and fully-developed non-bank intermediation.

Table 3.2

#### Banking sector indicators, 2002

	Total number of banks (foreign-owned)	Total number of banks per 100,000 inhabitants	Total assets (percentage of GDP)	Domestic credit (percentage of GDP)	Domestic credit to private sector (percentage of GDP)	Non-performing loans (percentage of total loans)	Total deposits (percentage of GDP)	Total capital	Asset share of five largest banks	Asset share of foreign banks	Asset share of state-owned banks	Interest rate margin
Albania	13(12)	0.38	48.6	44.9	6.8	5.6	41.4	3.1	85.8	45.9	54.1	6.0
Bosnia and Herzegovina	40(21)	1.05	50.9	12.2	13.0	11.5	38.2	7.5	63.1	76.7	6.2	8.2
Bulgaria	34(26)	0.43	46.2	25.2	18.4	10.4	35.6	6.3	55.5	75.2	14.1	6.6
Croatia	46(23)	1.04	98.6	63.8	51.6	11.5	64.5	9.2	63.4	90.2	4.0	9.4
FYR Macedonia	20(7)	1.00	38.6	18.2	17.9	35.7	22.8	8.0	73.6	44.0	2.0	8.5
Moldova	16(10)	0.38	32.4	29.9	17.6	7.6	18.1	6.9	71.0	36.7	13.4	9.1
Romania	31(24)	0.14	26.5	13.4	8.4	2.3	20.8	1.9	67.9	52.9	43.6	16.1
Serbia and Montenegro	50(12)	0.60	31.7	14.0	15.6	28.5	17.4	6.4	46.5	27.0	35.6	16.6
SEE	-	0.45	46.5	26.6	19.8	14.5	32.6	5.1	59.5	55.0	6.4	10.8
CEB	-	0.30	70.8	39.2	32.9	7.9	50.9	5.0	65.9	41.1	18.2	7.2
CIS	-	0.67	32.6	25.1	17.3	7.9	14.2	4.6	62.2	38.6	28.8	6.9
Eurozone	-	0.54	245.1	136.5	109.3	-	81.1	15.7	-	-	-	3.5

Sources: EBRD and IMF - International Financial Statistics.

<sup>7</sup> This qualitative measure of reform progress ranges in value from 1 (little progress in reforming the socialist banking systems) to 4+ (reforms consistent with a well-functioning market economy). See the note to Table 3.1 for a detailed definition of the financial sector reform transition indicators.

Chart 3.2

## Domestic credit in SEE, 2002

Percentage of GDP

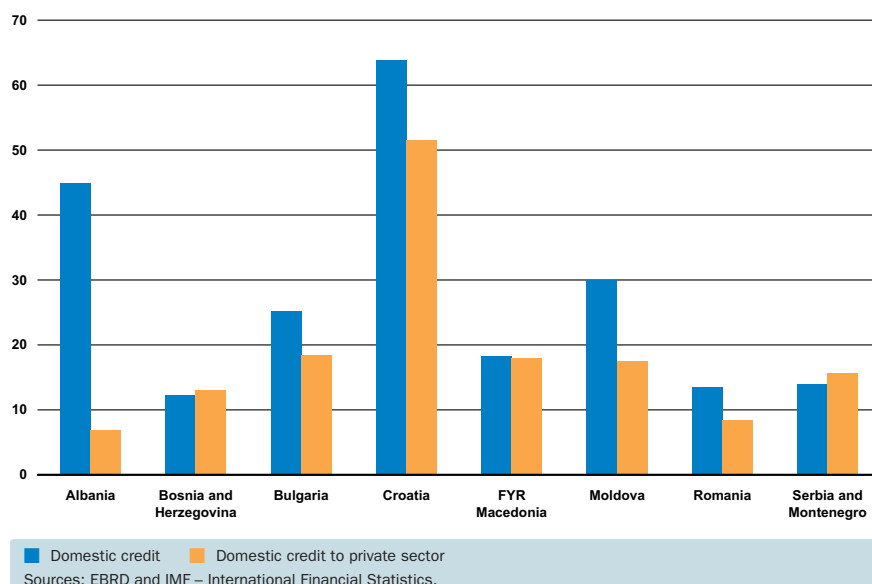
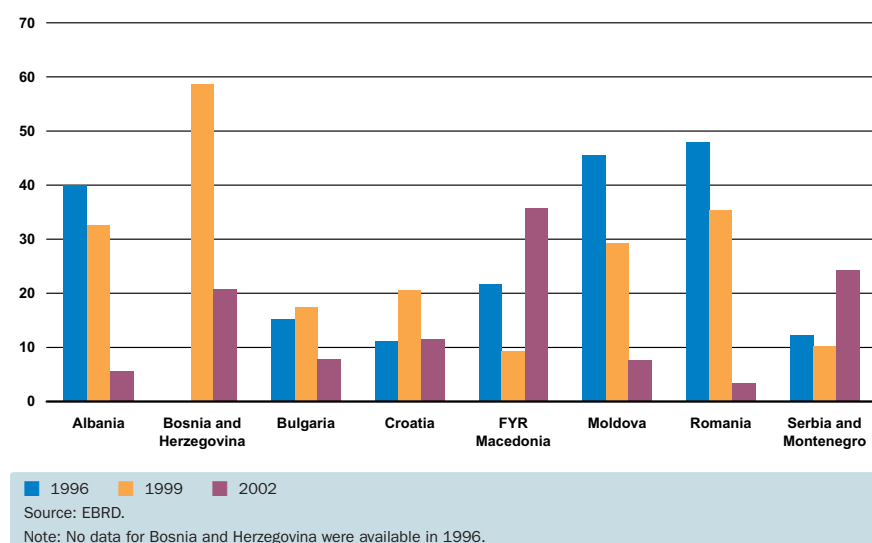


Chart 3.3

## Quality of bank lending, 2002

Percentage of non-performing loans to total loans



In several countries, signs of consolidation are now apparent; for example, the number of banks in Bosnia and Herzegovina decreased from 61 in 1999 to 40 in 2002, and from 53 to 46 in Croatia over the same period. Even greater consolidation took place in Serbia and Montenegro over the same period, with the number of banks falling by one-third. As reforms in the sector proceed, this process is likely to continue over the medium term.

## Financial intermediation

Financial intermediation can be measured in different ways, one of which is to look at the ratio of domestic credit to GDP, both for the whole economy and for the private sector only.

Chart 3.2 gives data on domestic credit ratios in the region at the end of 2002. For SEE as a whole, the ratio of total domestic

credit to annual GDP was 26.6 per cent (weighted average) – ranging from 12.2 per cent in Bosnia and Herzegovina to 63.8 per cent in Croatia – compared with the CEB regional average of 39.2 per cent. The corresponding figures for domestic credit to the private sector only were 19.8 per cent in SEE, compared with an average of 32.9 per cent in CEB. Lending to the private sector was particularly low in some countries, with a private sector credit-to-GDP ratio of less than 10 per cent in Albania and Romania.

The ratio of domestic credit to GDP (both for the whole economy and for the private sector only) is a crude measure of intermediation, not least because domestic credit may include non-performing loans (see Chart 3.3). These are significant in several countries of former Yugoslavia, where lending to shareholders of the bank and other related parties (so-called “connected lending”) used to be rife, although this problem is being addressed throughout the region, with particular success in Croatia.<sup>8</sup>

Two other criteria also point to the relative weakness of the banking sector in SEE. The first is the capitalisation of banks. The average (weighted) bank capital-to-GDP ratio at the end of 2002 was about 5.1 per cent in SEE, compared with 5.3 per cent in CEB. The ratio ranged from 3.1 in Albania to 9.2 in Croatia (see Table 3.2). Secondly, there is a large spread between deposit and lending rates, indicating a high degree of “inefficiency” as well as low competition in the banking sector.<sup>9</sup> As Table 3.2 shows, the spread was on average about 11 per cent in SEE at the end of 2002, which is well above the 6.9 per cent spread in CIS countries and the 7.2 per cent spread in CEB. Even in the most advanced countries of the region, such as Bulgaria, Croatia and Romania, more needs to be done to create an efficient banking sector.

## Explaining low intermediation: evidence from BEEPS

There are several reasons for the patterns of bank intermediation outlined above – for example, over-cautious behaviour of banks, lack of sufficient clients with the appropriate

<sup>8</sup> Non-performing loans include loans classified by banks as substandard, doubtful and loss. Any comparison between countries of the ratio of non-performing loans to total loans is problematic due to differences in the definition of loan classification.

<sup>9</sup> The efficiency of bank lending to the private sector is also indicated by the intermediation ratio – that is, the ratio of average loans to private sector to deposits. In SEE countries this ratio as of October 2003 ranged from 15 per cent in Albania to 97 per cent in Croatia.

risk-return profile, poor credit assessment skills, a weak legal framework for creditor protection, and a legacy of bad loans and banking crises. Many people in SEE remain distrustful of banks. At the end of 2002 the (weighted) average bank deposit-GDP ratio was 32.6 per cent, compared with 51 per cent in CEB and 81 per cent in the eurozone (see Table 3.2). Most deposits are short-term, contributing to the severe lack of long-term funding for enterprises.

The BEEPS contains further insights into difficulties in the SEE banking sector, especially for SMEs. Firms were asked how easy it was to obtain loans from commercial banks. On average, 54 per cent of enterprises in the region said that it was either fairly difficult or impossible to obtain short-term working capital loans from commercial banks, while 70 per cent of enterprises considered it difficult or impossible to get a long-term bank loan. This proportion was higher for SMEs, and for domestic privately owned enterprises than for foreign-owned companies. These difficulties were least marked in Croatia, where the corresponding percentages were 39 and 55 per cent.

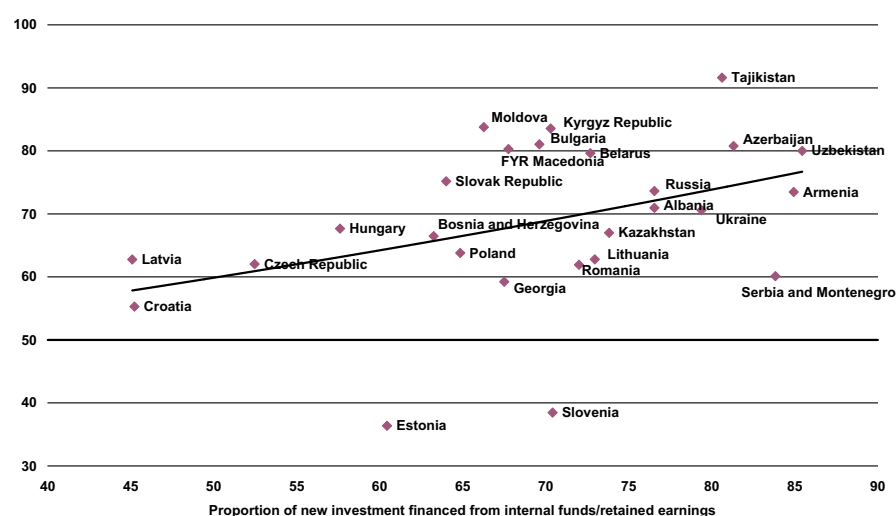
As noted earlier, firms typically compensate for the difficulty in obtaining finance from commercial banks by using internal funds for new investments. Chart 3.4 shows the proportion of firms in each transition country that thinks it is difficult or impossible to obtain long-term loans from commercial banks, together with the proportion of new investment financed from internal funds by firms. The chart indicates that countries in which firms have a greater proportion of internal financing for new investment perceive a greater difficulty in obtaining long-term bank financing.

The time needed to process a loan, and the collateral required by banks, are other problems identified by BEEPS respondents.<sup>10</sup> It takes 31 days on average across the region – varying from 13 days in Moldova to 53 days in Albania – for banks to decide on a loan application. Reflecting the weak creditor protection in much of the region,

Chart 3.4

### Enterprise access to bank finance and proportion of internal funds used for new investments

Proportion of firms reporting that access to long-term bank loans is difficult



Source: Business Environment and Enterprise Performance Survey (BEEPS), 2002.

Note: No data were available for Turkmenistan.

the average value of collateral required for granting a loan is 124 per cent of the value of the loan, varying from 73 per cent of the loan in FYR Macedonia to as high as 174 per cent in Bulgaria. When these problems are combined with high interest rates, it is not surprising that many firms resort to other sources of finance.

### Recent developments: privatisation and domestic credit expansion

There have been notable advances in recent years in the privatisation of local banks, often attracting foreign bank involvement, and the expansion of deposits and lending. Each of these is considered below.

In the most advanced transition countries, the driving force for improving financial services and efficiency in the banking sector is strong competition, which in turn has been promoted by privatisation and foreign banks' participation.<sup>11</sup> Bank privatisation has been slower in SEE than in CEB, but significant changes occurred between 1996 and 2002. Chart 3.5 shows the changing ratio of asset share of state-owned banks in total assets during this

period.<sup>12</sup> As of the end of 2002, Albania had the highest asset share of state banks at 54.1 per cent, followed by Romania and Serbia and Montenegro at 43.6 per cent and 35.6 per cent respectively. In contrast, bank privatisation was almost complete in Bosnia and Herzegovina, Bulgaria, Croatia and FYR Macedonia.<sup>13</sup> Moldova was the only country that increased the asset share of state banks between 1999 and 2002, possibly due to consolidation in the sector.<sup>14</sup>

As privatisation has progressed, the presence of foreign banks has increased significantly across the region. As of the end of 2002, the asset share of foreign banks in the region was 55 per cent, ranging from 27 per cent in Serbia and Montenegro to 90 per cent in Croatia (see Table 3.2).

The situation is changing rapidly in several countries of the region, where notable changes in ownership structure occurred in 2003. For example, Albania's largest and only remaining state-owned bank – the Savings Bank – was sold to Raiffeisen Bank of Austria. Also, in Bulgaria, the sale of DSK Bank, the former savings bank and the second-largest bank in terms of assets,

<sup>10</sup> See Fries et al. (2003).

<sup>11</sup> Studying the factors that have affected real loan growth of banks in transition economies, Fries and Taci (2002) conclude that privatised banks and those with higher capital-asset ratios are expanding more rapidly than state-owned banks. Furthermore, privatised banks, and especially those sold to foreigners, are more efficient than domestically owned banks (see Fries and Taci, 2004).

<sup>12</sup> Figures for 1996 were not available for some countries.

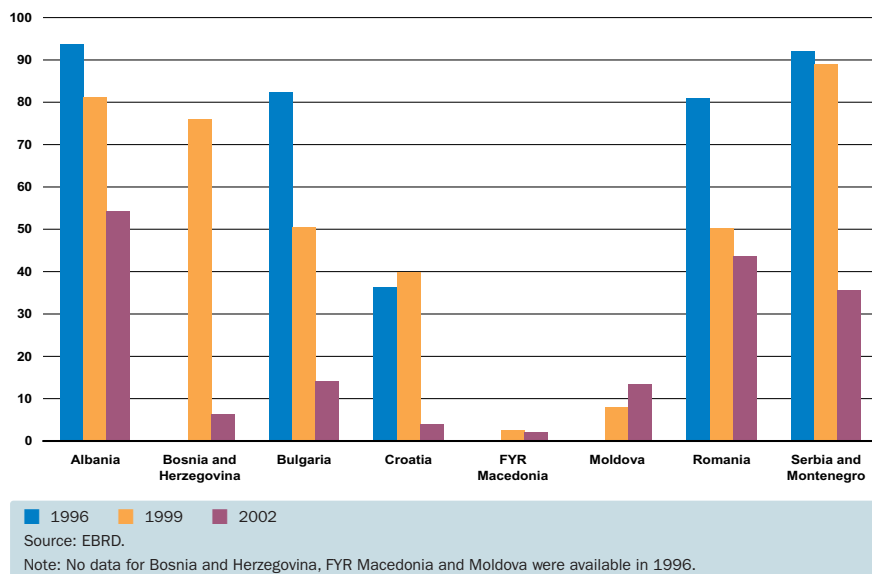
<sup>13</sup> Croatia has two remaining state-owned banks for sale (Croatia Banka and Croatian Post Bank).

<sup>14</sup> In 1999 there were 20 banks; this was reduced to 16 by 2002. However, the banking sector is still considered too big in relation to the local market (see EBRD, 2003).

Chart 3.5

## Progress in bank privatisation, 1996-2002

Share of assets in state banks (in per cent)



other countries, 12 large banks have been taken back into state hands in preparation for privatisation over the coming years.

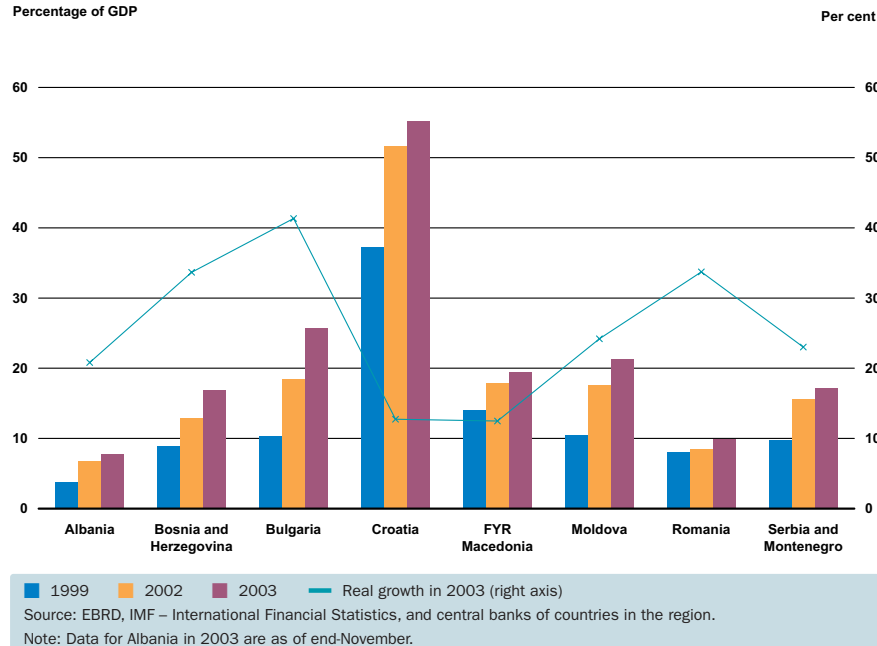
At least three are expected to be privatised during 2004.

As of early 2004, data show that people in the region are gaining confidence in the banking sector. Data from the IFS show that there has been a significant increase in the deposit-GDP ratio during the previous two to three years. For example, the ratio increased from 21 per cent in 2000 to about 37 per cent in 2003 in Bosnia and Herzegovina, from 27 to 40 per cent in Bulgaria, and from 48 to 70 per cent in Croatia. Even in Moldova the ratio rose from 14 to 26 per cent over the same period. The changeover to the euro in the EU at the start of 2002 encouraged large sums of hoarded cash to be channelled into the financial system in many SEE countries. The fact that much of it has stayed in the banking sector implies a growing trust in banks.

Chart 3.6

## Recent growth in domestic credit to the private sector

Percentage of GDP



In line with this growth in deposits, Chart 3.6 shows that domestic credit to the private sector has also seen a significant increase across the region during 2002-03.<sup>16</sup> The more advanced countries of the region, such as Bulgaria and Romania, have seen the largest increases by 41 and 34 per cent respectively in real terms.<sup>17</sup> However, significant real growth in lending to the private sector has also occurred in less advanced countries such as Albania, Bosnia and Herzegovina, FYR Macedonia and Moldova.<sup>18</sup> While the role of banks remains relatively small, the sector is nevertheless becoming more important in private sector development. Bank credit to households (including consumer credit and mortgage loans) played an important contribution to the growth of domestic credit to the private sector during 2003 across the region. In particular, bank credit to households doubled in real terms in Romania, increased by 70 per cent in Serbia and Montenegro (albeit from a low base) and by 66 per cent in Bulgaria.<sup>19</sup>

virtually completed the privatisation of the banking sector in that country.<sup>15</sup> In Romania the privatisation of the largest bank, Banca Comerciala Romana, began with the sale

of 25 per cent of shares to the EBRD and the International Finance Corporation (IFC). In Serbia and Montenegro, which started the transition process later than most

<sup>15</sup> Following the sale of DSK, Encouragement Bank and the Municipal Bank of Sofia (owned by the municipality) are the only two remaining publicly owned banks in Bulgaria.

<sup>16</sup> Some of the growth in bank credit may involve the substitution of formal for informal credits.

<sup>17</sup> In Bulgaria and Romania the significant increase in lending to the private sector is partly explained by the availability of new sources of finance, such as leasing and mortgage loans, on the one hand, and by a change in the debt management policy of the Government, with a higher reliance on external sources of finance, on the other. The declining amount of treasury bills (T-bills) available on the secondary markets (and the fall in their rate of return) contributed to the fall in the amount of these T-bills in the banks' balance sheets and to an increase in bank lending, as the T-bills were no longer a good investment for banks.

<sup>18</sup> Although growth in bank lending to the private sector is desirable, a large increase in lending also calls for capacity-building in domestic banks and domestic businesses, as well as enhanced monitoring of bank performance.

<sup>19</sup> Data are taken from the relevant central bank web sites.

### 3.3 Alternative sources of finance

This section considers the role of alternatives to conventional bank lending as domestic sources of finance for private enterprise.

#### Micro-finance institutions

A number of international financial institutions (IFIs) and donors have helped to create dedicated channels for financing private sector enterprises (in particular, micro, small and medium-sized enterprises) in the SEE region, such as micro-finance banks and credit lines. In many cases, support from the public sector and non-governmental organisations is also provided for investment activities that are not normally handled by commercial banks, such as new businesses. More details on micro-finance institutions are provided in Box 3.2.

#### SME credit lines

Another important way that IFIs can help SMEs is through dedicated credit lines for SME borrowing through local banks. Box 3.3 outlines some innovative joint approaches by the EBRD and donors that have been successfully applied in accession countries, including Bulgaria and Romania, and in some cases to the western Balkans. An aspect of credit lines that needs to be addressed, however, is their sustainability. Many commercial banks rely on funds provided by the IFIs for on-lending to SMEs. In addition, legal and regulatory barriers in the SEE region continue to impede the development of such dedicated mechanisms for providing assistance to small enterprises.

#### Government programmes

Funding programmes provided by the governments in the region have had mixed results. A number of weaknesses have been identified, particularly the high administrative costs of setting them up, the fact that governments sometimes use these programmes as a substitute for implementing structural reforms, and their poor record in other emerging markets.<sup>20</sup> In SEE, governments are often ill-prepared to intervene in the credit market without

#### Box 3.2

##### Micro-finance banks

Micro-enterprises – defined as firms with less than 10 employees – have typically been ignored by most banks as lending to them is considered labour-intensive, risky and unprofitable. As a result, they have frequently chosen to operate in the informal economy, and do not therefore provide tax returns or prepare business plans. However, this prevents them from negotiating with potential lenders about their creditworthiness based on traditional criteria. New micro-finance banks have been created to concentrate solely on the needs of this market. Various international donors and financial institutions (including the EBRD), as well as some local banks, provide grants and subsidised funding to these new institutions to support start-up costs. They also provide initial funding for lending activities while a new institution becomes known in the local market and starts building up its own deposit base. The US government has provided substantial funds for technical assistance, on-lending and loss guarantees.

Micro-finance institutions are established in all countries of the SEE region, with the exception (as of early 2004) of Croatia. They are having a significant impact, allowing access to financing for entrepreneurs and small and micro-businesses. To do this, they use cash-flow analysis as a way of assessing credit-worthiness. Data from the EBRD show that, on a cumulative basis up to the end of 2003, these banks (including ProCredit Bank in Kosovo) had granted over 87,000 small loans to the value of €458 million (with an average loan amounting to around €5,250). They are becoming increasingly sustainable, generating more of their own funds from deposits and retained earnings, decreasing their reliance on IFIs for sources of finance, and aiming to ensure that their lending activities will be maintained when international technical assistance comes to an end.

#### Box 3.3

##### SME Finance Facilities and credit lines

International donors have played a significant role in providing facilities and credit lines for SMEs in SEE. In 1999 the EU and the EBRD devised the EU/EBRD SME Finance Facility to promote access to finance for SMEs in the 10 accession countries (including Bulgaria and Romania in SEE) where the EBRD is financing investments. This facility provides finance for SMEs through participating banks and leasing companies, together with technical assistance to improve the banks' lending skills. It also includes a performance incentive, designed to offset the banks' operating costs associated with lending to what is considered to be the riskiest area of the enterprise sector. The main objective of this facility is to encourage local banks and private equity funds to expand their SME operations over the medium- to long-term. By the end of 2003 the EBRD had committed €128 million in loans in the two SEE accession countries through four banks in Bulgaria and six in Romania, while the EU had provided €23 million in grants for technical assistance and performance fees. These 10 banks had extended over 6,050 loans to SMEs amounting to around €171 million by the end of 2003.

Building on the success of this programme, the EBRD is working with the EU to develop a similar SME Facility for the western Balkans. As of early 2004, negotiations were under way to start lending to SMEs through banks (using technical assistance provided by the EU) in Serbia (including Kosovo) and FYR Macedonia. The German organisation KfW has managed similar programmes with good results in these markets. Another important example of donor support is the US/EBRD SME Finance Facility introduced in 2000 to support enhanced access to financing for SMEs throughout SEE as well as in other early and intermediate transition countries. The EBRD has considerable experience of credit lines in the western Balkans, as well as in Moldova. For example, by the end of 2003 it had provided a total of more than €270 million in credit lines to local banks in Croatia (€187 million), Moldova (€30 million), Bosnia and Herzegovina (€36 million) and FYR Macedonia (€20 million), all without specialised technical assistance. In some countries, such as Croatia, banks are increasingly willing to accept the risk associated with a "mismatch" between the maturity of assets and liabilities as their deposit bases grow.

creating distortions. Credit guarantee schemes have not, therefore, been operating effectively. To overcome the inefficiencies, suggestions have been put forward to set

up mutual guarantee schemes by groupings of SMEs,<sup>21</sup> promoting closer business links and also improving banks' knowledge of the markets of their SME clients.<sup>22</sup>

<sup>20</sup> See UNIDO (2003).

<sup>21</sup> For example, crafts, retailing, or other small firms that do not have access to loans.

<sup>22</sup> See, for example, a proposal by the European Commission, available at [http://europa.eu.int/comm/enterprise/entrepreneurship/financing/mutual\\_guarantees](http://europa.eu.int/comm/enterprise/entrepreneurship/financing/mutual_guarantees).



## Stock markets

Stock exchanges are the main institutions of the existing capital markets in SEE. However, while progress has been made in institutional reforms and in the volume of trading, stock markets in all transition countries, and especially in SEE, remain underdeveloped. Regulated capital markets have been operating in most SEE countries since the mid-1990s, but they are typically small and fragmented, with low liquidity and inexperienced management.<sup>23</sup> Bulgaria, FYR Macedonia, Moldova and Romania launched their stock markets between 1992 and 1996 to facilitate the concentration of ownership following mass voucher privatisation. Croatia established a stock market in 1991, with a small number of stocks offered by direct sale through initial public offerings (IPOs).

However, after an initial increase, the number of listed companies on the stock exchanges in countries that used the voucher privatisation scheme decreased significantly; many companies were de-listed as their ownership structure became concentrated.<sup>24</sup> In Bulgaria the number of listed companies decreased from 998 in 1998 to 354 in 2002. In Romania the fall was less dramatic, but the number of companies listed decreased from 5,753 to 4,870. Relative to the size of the economies that they serve, even the largest stock markets in the SEE region are small. Only Croatia and Romania have stock markets with a capitalisation of more than US\$1 billion. The ratio of stock market capitalisation to GDP is small across the region, reaching only 16 per cent in Croatia and 10 per cent in Bulgaria by the end of 2002. This compares with a capitalisation of 21 per cent in the Czech Republic, 34

per cent in Estonia and 37 per cent in Russia (at the same point in time), while in the European Union market capitalisation often exceeds the value of GDP.<sup>25</sup>

Market liquidity is also very modest in SEE compared with other transition countries. At the end of 2002, market turnover, defined as the value of trading relative to market capitalisation, reached 9 per cent in Romania, 15 per cent in FYR Macedonia and 26 per cent in Bulgaria; in Russia and Kazakhstan it was 29 per cent and in the Slovak Republic it reached 46 per cent.<sup>26</sup> Furthermore, concentration in these markets is substantial, with many regional stock markets dominated by a small number of large firms.

## Fixed income

Fixed income markets tend to be more developed than stock markets in SEE. However, the most active fixed income markets in the region consist of treasury bills, and maturities of bond issues, including those by governments, have rarely extended beyond one year. Most of the issuers are central governments, government-related enterprises and local authorities, but in more advanced countries of the region (Bulgaria, Croatia and Romania) a small number of corporations and banks have started issuing international debt securities. For example, Termoelectrica, a thermal power generation company in Romania, issued an international bond at the end of 2002, and Bina Istra, a construction company in Croatia, issued one in 2003. As macroeconomic stability has improved, the length of maturities has increased in recent years.<sup>27</sup>

## 3.4 Conclusions

This chapter has shown that, notwithstanding recent progress, access to finance is one of the main barriers to enterprise development across the SEE region. Many enterprises, especially in the SME sector, rely mainly on internal funds to finance new investments. Bank intermediation is quite low, despite the large number of banks in the region, and other sources of finance, such as stock markets or leasing, are still in their infancy. There are several reasons for the low level of financial intermediation. A weak judiciary and legal framework, lack of appropriate credit skills and long-term resources, and the legacy of mistrust in the banking system are all contributing factors. In addition, the time taken to process loans, and the level of collateral required by banks, are further discouragements.

There have been significant improvements over the past year. Bank reform has made progress in a number of countries, and greater participation by foreign banks has had a positive effect on the efficiency of the banking system. Privatisation in the sector is nearly complete in most countries, with new ownership encouraging greater competition, credit growth and rising deposits.

In conclusion, governments and international institutions still have a vital role to play in providing finance, especially to SMEs. Micro-finance institutions and IFI-supported SME credit lines through local banks have also helped in expanding the level of credit available in the economy. Government-run programmes have generally been less successful, but governments can still play an enabling role by strengthening the legal framework for enterprises.

<sup>23</sup> For example, there are two stock exchanges operating in Bosnia and Herzegovina but with weak links between them.

<sup>24</sup> Some studies show that transition economies demonstrate a strong link between privatisation and capital markets – see, for example, Perotti and Van Oijen (1999) and Megginson and Netter (2001). However, those countries which had mass privatisation using vouchers did not have any gains as these took place outside the stock markets.

<sup>25</sup> Nevertheless, the return of the stock markets in some advanced countries of the SEE region has recently outperformed some countries in CEB, making them attractive for investments which in turn will support their future development. In 2003 stock market return (measured by the IFC total return Index) in Bulgaria was 193 per cent compared with 80 per cent in eastern Europe and 59 per cent in emerging markets overall.

<sup>26</sup> The data for numbers of listed companies, stock market capitalisation, and turnover are taken from Standard & Poor's/International Finance Corporation (SP/IFC), Emerging Market Data Base, for Bulgaria, Croatia, Moldova and Romania, and from local stock exchanges for other countries.

<sup>27</sup> See also EBRD (2003b, Chapter 2).

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# International sources of finance for investment

# 4

A successful transition to a market economy cannot be financed solely from domestic sources. Capital inflows from abroad play a vital role in the process. The year 2003 saw net capital inflows to all transition countries of about US\$ 26 billion, the highest level since 1998.<sup>1</sup> Approximately 40 per cent of the total (around US\$ 10.3 billion) went to the SEE region. This chapter analyses how these inflows are broken down into different types of capital, where the money is being invested, and the prospects for enhanced inflows in the future.

The chapter begins by describing the main trends in total net capital inflows to the region, divided firstly into different types – foreign direct investment (FDI), portfolio flows, and other investment such as international bank lending – and secondly into official and private flows. This is followed by an analysis of the composition of FDI to SEE by countries of origin and sectors of destination. The chapter then evaluates the potential for FDI to SEE to increase over the medium term. Three issues are considered: the possibility of attracting new greenfield investment, given that privatisation is well advanced in most countries and the stock of attractive, state-owned assets is falling; whether investors may see the different countries of the region as part of a greater whole; and the attractiveness of the region, relative to others, in terms of corporate tax rates and labour costs. Finally, the chapter summarises the main conclusions.

## 4.1 Net capital inflows

The upheavals of the 1990s and the slow pace of transition hindered the integration of SEE into international capital and financial markets. However, recent years have seen an increase in investor interest in the region, and a consequent sharp rise in its share of net capital inflows to emerging markets.

As Chart 4.1 illustrates, net capital inflows to all transition countries (including SEE) have fluctuated widely from year to year, largely driven by wide variation in annual capital flight from Russia. Throughout the

Chart 4.1

**Total net capital inflows to all transition countries and to SEE as a percentage of total inflows to emerging markets, 1989-2003**

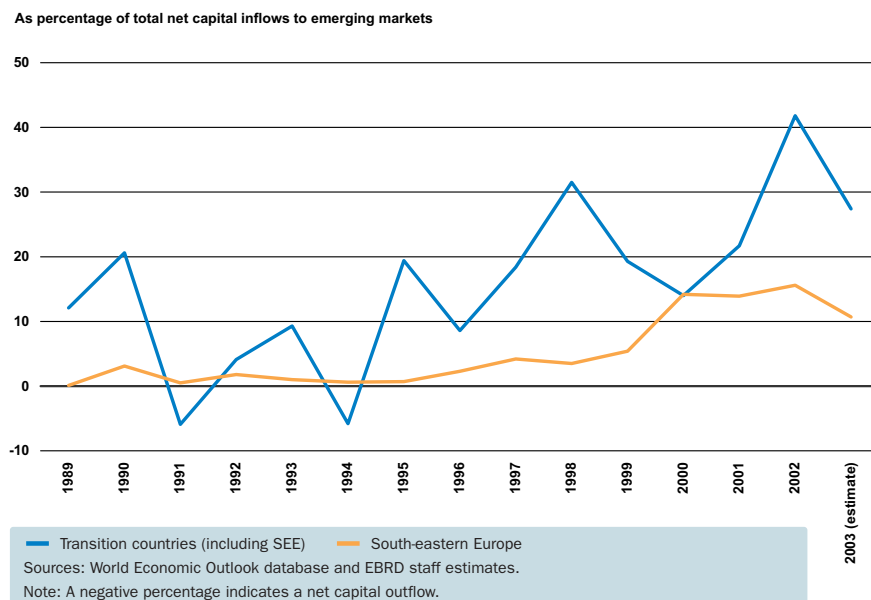
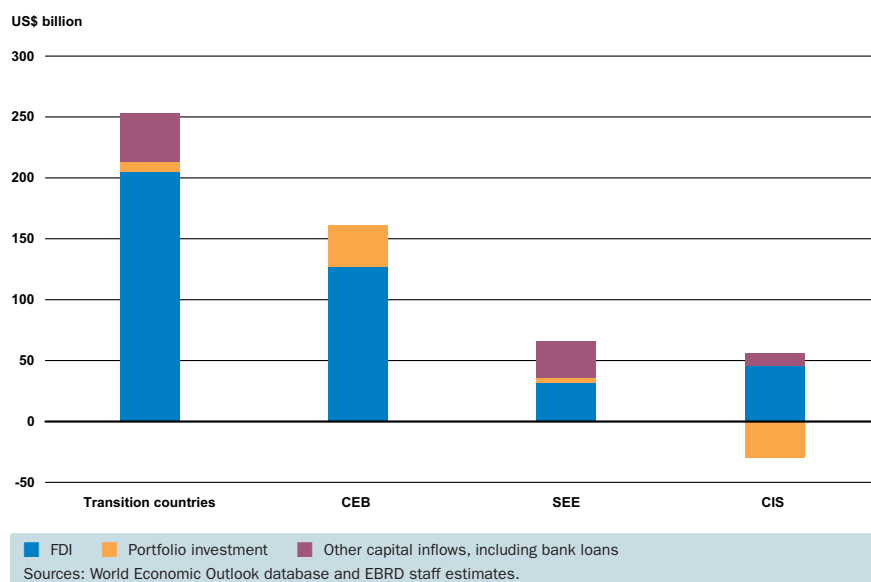


Chart 4.2

**Cumulative net capital inflows to transition countries, 1989-2003**



1990s the SEE share was little more than one-quarter of total capital inflows to transition economies and never more than about 4-6 per cent of the total going to all emerging markets. Political instability and

the relatively late start of the privatisation and reform programmes partly explain this poor record. But in recent years, many emerging markets in Latin America and East Asia have suffered a downturn in

<sup>1</sup> See IMF (2003a).

## Box 4.1

## Capital flows: sources and definitions

Statistics on international capital flows are often confusing and subject to misinterpretation. This box explains what the different terms mean.

Further details can be found in the IMF's World Economic Outlook (the main source of data for this chapter) and IMF (2003b).

*Private and official capital inflows:* these are classified according to the nature of the investing agent/institution rather than the beneficiary.

*Foreign direct investment:* FDI is defined as flows of international investment that reflect the objective of a resident in one country (the direct investor) to acquire a lasting management interest in an enterprise resident in another country (the direct investment enterprise).<sup>1</sup> This lasting interest may involve the establishment of new facilities abroad, commonly known as greenfield investment, the creation of joint ventures, or the acquisition of an existing enterprise abroad.<sup>2</sup>

A direct investment relationship is established when the direct investor has acquired at least a 10 per cent equity share of an enterprise abroad. After the initial investment, all the subsequent capital transactions between the direct investor and the investment enterprise are recorded as direct investment. This incremental FDI can take the form of additional equity injections, reinvested earnings or inter-company debt.

*Net, gross and stock of FDI:* net FDI inflows are the difference between total investments during the reporting period minus total disinvestments.<sup>3</sup> Gross FDI is a measure of the inward flow. In most SEE countries, there is little difference between the two figures, as little outward investment has occurred from this region. The stock of FDI is the market value of the

share of capital and reserves (including retained profits) of the parent enterprise. However, some sources, including the United Nations Conference on Trade and Development (UNCTAD), report FDI stocks at the book value rather than market value because the latter may be difficult to determine for companies that are not quoted on the stock market.<sup>4</sup>

*Net portfolio inflows:* these are defined as bond and non-debt equity securities (the sum of country funds, depository receipts, and direct purchases of shares by foreign investors) issued by a country and purchased by foreigners, net of similar assets issued by other countries and held by domestic private and institutional investors.

*Other net capital inflows:* these include short- and long-term trade credits; loans from outside the country, including bank loans (both from international financial institutions and from other banks and lending institutions); currency and deposits.

<sup>1</sup> See IMF (2003b) for an overview of the available statistics on FDI.

<sup>2</sup> Financial transactions involving Special Purpose Entities (SPEs), which are often established in off-shore locations to benefit from tax breaks and other incentives available to foreign investors, should in principle be recorded as FDI.

<sup>3</sup> For recording purposes, FDI flows are measured on a directional basis and recorded as an asset for the country of residence of the direct investor and as a liability for the economy of the direct investment enterprise. A net increase in the liabilities of a country would therefore indicate an inward FDI flow.

<sup>4</sup> If mergers and acquisitions transactions are made at a market price that exceeds the book value of the direct investment company, the financial flow recorded in the balance of payments and the corresponding change in stock would then differ.

investor interest. This factor, combined with growth and reform progress, led to a much greater proportion of international capital going to transition economies. SEE attracted 16 per cent (US\$ 10.1 billion) of the emerging market total in 2002.

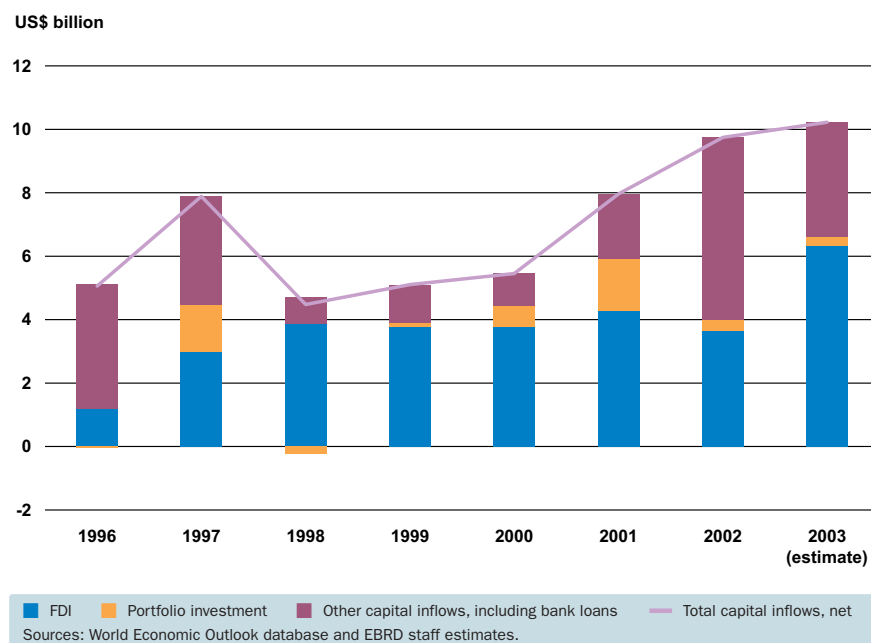
Although this is a positive trend, it should be noted that net cumulative capital inflows to SEE from 1989 to 2003 totalled US\$ 66 billion (see Chart 4.2), little more than a quarter of the US\$ 253 billion total net cumulative flows to transition countries over the same period. The bulk of international capital earmarked for transition countries (about 65 per cent) has gone to the countries of CEB.

## Types of capital inflows

There are different types of capital inflows – see Box 4.1 for some definitions. FDI is the most important type, both in size and in terms of impact on private sector development. FDI accounted for more than 80 per cent of net cumulative capital inflows to transition economies from 1989 to 2003, but for only 50 per cent to SEE over the same period. Countries in SEE rely on other sources of capital, particularly net international bank lending, to a greater extent than those in CEB. However, Chart

Chart 4.3

## Total net capital inflows to SEE by type, 1996-2003



4.3 shows two encouraging points. First, annual net FDI inflows have been stable between 1998 and 2002, typically around US\$ 3.5-4 billion. Second, 2003 saw a notable increase to more than US\$ 6 billion, a record level for the region.<sup>2</sup> This impressive 70 per cent (year-on-year) increase in net FDI inflows to SEE came

mainly from progress in large-scale privatisation (especially in Croatia, with the partial privatisation of the oil company INA and in Serbia, with lucrative privatisations in the tobacco and oil sectors) and increased greenfield investment in the region.

<sup>2</sup> Data for 2003 are preliminary EBRD estimates and may be subject to further revisions.

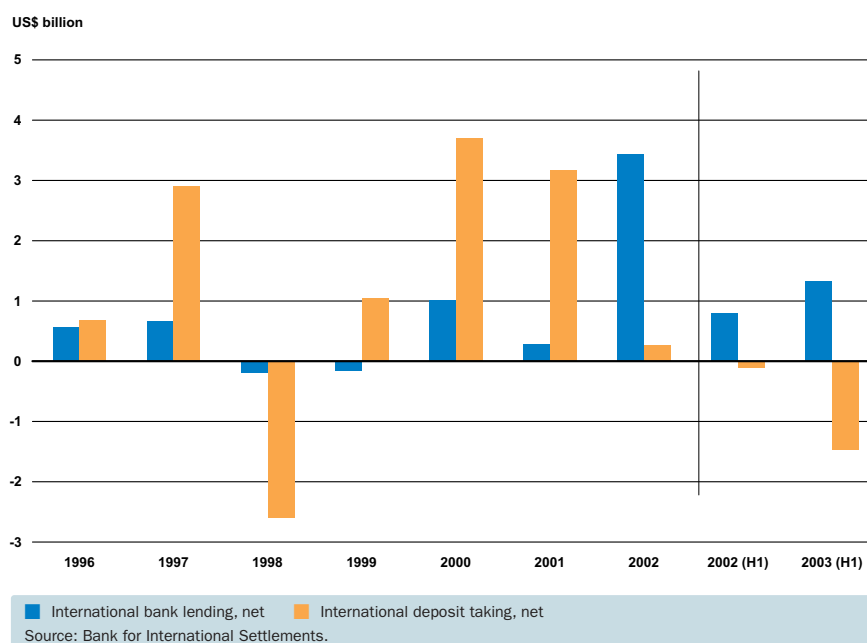
Net cumulative portfolio inflows to SEE have been limited to about US\$ 4 billion between 1989 and 2003 (see Chart 4.2); on an annual basis, net portfolio inflows have been negligible, with the exception of 2001 (see Chart 4.3). This is a reflection both of the presence of capital controls in many SEE countries (which have prevented inflows of short-term capital)<sup>3</sup> and of the limited access to international capital markets by both the government and private companies in SEE. Only Bulgaria, Croatia and Romania have received significant portfolio inflows during the transition. Most of these have been attracted to the region through sovereign bonds issued on the international markets, while only a few banks and private companies have issued bonds on these markets.

Other net capital inflows, including loans both from international financial institutions (IFIs) and from other banks, are the second-largest component (after FDI) of total capital flows to SEE, amounting to about 35 per cent of total net capital inflows to the region in 2003. This category is much more volatile than FDI. One component is net international bank lending, which increased significantly in 2002 (to US\$ 3.4 billion from US\$ 0.3 billion in 2001, see Chart 4.4). According to recent figures from the Bank for International Settlements (BIS), the net inflow in the first half of 2003 was 50 per cent higher than it was over the same period of 2002.

Croatia is the only SEE country that receives net inflows of international bank lending that are comparable to CEB countries. In 2002 the country attracted about US\$ 2.5 billion. Recent data suggest that local entities in Croatia, and to a lesser extent in Romania, may be increasing their borrowing on the international markets, benefiting from international interest rates below domestic rates. They may also be buying domestic assets in the expectation that the local currency will appreciate as convergence with the European Union (EU) occurs.<sup>4</sup> While this phenomenon, known as “convergence plays” strategies, can reduce debt servicing and repayment costs in the future, it also exposes borrowers to higher

Chart 4.4

#### International net bank lending and deposit taking by SEE banks, 1996-2003



exchange rate risk that in some cases may not be properly hedged.

The recent increase in the category “other net capital inflows” is also caused partly by a significant fall in deposit takings and other net claims on international banks by entities in the countries of the region. The right-hand bar in Chart 4.4 shows that the net inflow of SEE economies’ claims on international banks decreased to US\$ 0.3 billion in 2002 from US\$ 3.2 billion in 2001. This was largely the result of a significant reduction in deposits kept abroad by Croatian and Romanian banks. In contrast, financial institutions in Bosnia and Herzegovina and Serbia and Montenegro still held a significant proportion of their capital abroad in 2002, although this trend seems to have reversed in 2003 judging from preliminary figures for the first half of the year. Indeed, the net outflow from SEE countries in 2002 turned into a re-inflow of US\$ 1.5 billion in the first half of 2003. It may be that banks in SEE are drawing down their international deposits either to buy domestic assets because they are attracted by relatively higher domestic yields, or to increase domestic lending.

#### Private and official inflows

Chart 4.5 shows the breakdown of total net capital inflows to SEE into official sources, including IFIs, and private sources. Most of the net inflows come from the private sector – almost 90 per cent of the total in 2003. The record year for net private inflows was 2003, totalling US\$ 9.1 billion. Most of this capital has gone to the more advanced transition countries of the region – Bulgaria, Croatia and Romania – while the others have relied more heavily on official sources of financing. Net total official inflows fell by an estimated 30 per cent in 2003 relative to the previous year. Further reductions are expected over the medium-term for the western Balkans, highlighting the importance of attracting enhanced private inflows.

The EU has been a key source of official inflows to the region. In cumulative terms, SEE has received about €14 billion of EU assistance from 1991 to 2003 through various programmes.<sup>5</sup> The two accession countries, Bulgaria and Romania, together account for more than 40 per cent of this total, while Serbia and Montenegro (including Kosovo) has received 21 per cent and Bosnia and Herzegovina 18 per cent.

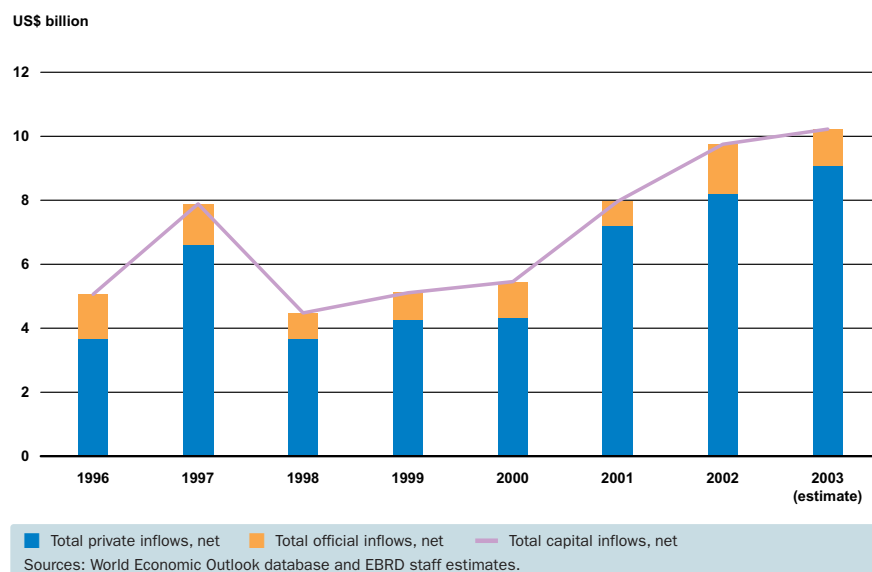
<sup>3</sup> These controls are being gradually phased out in the two EU accession countries, Bulgaria and Romania, which have to liberalise their capital account before EU entry.

<sup>4</sup> See also EBRD (2003a).

<sup>5</sup> Data in these paragraphs are from the European Commission and refer to selected EU assistance programmes such as CARDS, ECHO, Phare, SAPARD, ISPA and Tacis. For more detailed information see [http://europa.eu.int/index\\_en.htm](http://europa.eu.int/index_en.htm) and <http://europa.eu.int/comm/europeaid>.

Chart 4.5

## Total net private and official capital inflows to SEE, 1996-2003



The cumulative figures conceal a divergence in trends within the region. For the western Balkans and Moldova, EU assistance reached a peak of €1 billion in 2001 and has declined since then. In contrast, EU assistance to Bulgaria and Romania increased sharply in 2000, when a number of pre-accession programmes (ISPA, SAPARD and Phare) were launched or extended in scope following the formal invitation from the EU to both countries in December 1999 to start membership talks. From 2001, these two countries have been the major recipients of EU funds to SEE, with combined total disbursements of about €1 billion on average per year. In 2003, they accounted for about 80 per cent of the total funds committed by the EU for SEE.<sup>6</sup>

For several western Balkans countries the recent drop in official EU assistance has been significant in terms of GDP. In Bosnia and Herzegovina, for example, the ratio of EU funds to GDP decreased from 12.6 per cent in 1996 to a committed 1 per cent in 2003. At a regional level, however, the large rise in net FDI inflows in 2003 has more than compensated for the fall in official EU assistance. Nevertheless, as EU and other donor aid to the western Balkans is likely to fall further, SEE countries must continue to develop their private sector activities to attract increasing levels of FDI.

To summarise the discussion so far, most capital going to the region is FDI, the level of which is rising. This is encouraging, as FDI inflows are longer term and less volatile than portfolio or other forms of capital inflows. The benefits of FDI include faster enterprise restructuring and adoption of technological innovation in companies that have benefited from foreign participation and, at a macroeconomic level, higher GDP growth.<sup>7</sup> The rest of this chapter focuses on the sources and destinations of FDI, and on what can be done to encourage even more investors to the region.

Table 4.1

## Leading investors in SEE countries, 2002 (percentage of FDI stocks)

Albania		Bosnia and Herzegovina		Bulgaria		Croatia	
Italy	47.9	Croatia	13.6	Germany	13.0	Austria	22.9
Greece	34.2	Kuwait	12.8	Italy	12.2	Germany	22.6
FYR Macedonia	2.2	Slovenia	10.9	Greece	11.2	US	15.2
Turkey	2.0	Germany	10.2	Austria	9.5	UK	10.3
France	1.3	Austria	10.1	US	8.7	Luxembourg	5.6
Germany	1.3						
FYR Macedonia		Moldova		Romania			
Hungary	38.0	Russia	25.0	Netherlands	17.6		
Greece	24.7	US	16.4	Germany	9.9		
Cyprus	8.2	Spain	6.8	US	7.9		
Germany	5.0	Netherlands	6.8	France	7.3		
Liechtenstein	4.6	UK	6.7	Austria	6.2		

Source: Vienna Institute for International Economic Studies (WIIW).

Notes: Data are inward FDI stocks at end-2002. Figures for Albania, FYR Macedonia and Moldova refer to 2001. Comparable data on Serbia and Montenegro were not available.

<sup>6</sup> In 2002, the EU and the World Bank projected a fall in total donor assistance to the western Balkans from €3.9 billion in 2002 to €3 billion in 2003, but a rise to Bulgaria and Romania from €2.6 billion to €3.2 billion over the same period. See the 2002 annual report of the EU/World Bank Joint Office for South East Europe, available at <http://www.seerecon.org/joreport2002/pdf/joreport2002.pdf>.

<sup>7</sup> On the relationship between growth and FDI, see, among other studies, Borensztein et al. (1998), and Lankes and Venables (1996). On the impact of FDI at the enterprise level, see Barrell and Holland (2000), and Bevan et al. (2003).

Table 4.2

**Distribution of FDI in SEE by sector, 2002 (percentage of total FDI stocks)**

	Albania	Bosnia and Herzegovina	Bulgaria	Croatia	FYR Macedonia	Moldova	Romania
Industry	42.3	55.5	38.2	36.4	25.1	79.5	54.5
Transport and telecommunications	-	0.9	13.5	26.3	45.5	5.5	8.5
Financial intermediaries	-	16.5	19.4	22.9	23.7	0.0	-
Trade	27.2	6.2	15.0	5.7	3.0	12.8	16.1
Property	-	-	4.2	1.8	-	-	-
Agriculture	-	-	0.3	0.3	-	-	0.8
Tourism	-	0.7	1.8	4.2	0.5	2.1	2.1
Construction	6.2	-	2.8	1.1	0.2	-	2.7
Others	24.3	20.2	4.8	1.3	2.0	0.1	15.3

Source: Vienna Institute for International Economic Studies (WIIW).

Notes: Data are inward FDI stocks at end-2002. Figures for Albania, FYR Macedonia and Moldova refer to 2001.

Comparable data on Serbia and Montenegro were not available.

## 4.2 FDI composition

Tables 4.1 and 4.2 show which countries are the main investors in the SEE region and in what economic sectors.<sup>8</sup> Table 4.1 gives the top five investors in total FDI stock in 2002 for each SEE country. Their share varies from 49 and 55 per cent in Romania and Bulgaria respectively, to 89 per cent in Albania.

Geographical proximity to core markets and historical and cultural links between investor and recipient countries are key factors in investment decisions.<sup>9</sup> The data in Table 4.1 illustrate this point. For example, Italy and Greece accounted for more than 80 per cent of the total inward FDI stock in Albania, while FDI from Russia represented 25 per cent of the total inward stock of FDI to Moldova.

A recent development has been the growth in outward FDI from several transition economies – for example, the acquisition by a consortium led by the Hungarian company Matav of a majority share in Maktel, the fixed-line telecommunications company in FYR Macedonia, in January 2001, making Hungary the largest investor in FYR Macedonia as of 2002. Within the region,

Croatia is the top investor in Bosnia and Herzegovina, and Croatian firms are now expanding into the Serbia and Montenegro market, as witnessed by the recent example of the purchase of Frikom, the largest ice-cream and frozen food manufacturer in Serbia and Montenegro, by Agrokor of Croatia (see Box 4.2).

Table 4.2 shows the distribution of FDI by sector in the recipient countries. FDI in SEE tends to be concentrated in manufacturing and general industry. This suggests that manufacturing companies in neighbouring EU countries, such as Italy and Germany, are moving their industrial production activities eastwards to take advantage of the comparatively cheaper labour force.<sup>10</sup> This strategy has been followed in most cases by direct investment, either in existing companies due for privatisation or restructuring or in the construction of new manufacturing plants.<sup>11</sup> The key challenge now is to shift FDI from labour-intensive to more sophisticated capital-intensive sectors.

Investment in other sectors is driven largely by whether or not privatisation has taken place. The tourism sector has attracted some foreign investment in Croatia and

### Box 4.2

#### Intra-regional FDI: the case of Frikom

An example of cross-border FDI within SEE occurred in the agribusiness sector in February 2003. As part of its expansion strategy, the Croatian company Agrokor, the largest food company and leading ice-cream producer in that country, acquired a 55 per cent stake in a Serbian company, Frikom, through a purchase from the Serbian government. The acquisition was a landmark deal, and a sign of the new business relations between Croatia and Serbia. It was the first significant cross-border investment of a Croatian food company in Serbia and Montenegro in recent times, and marked an important step towards the reintegration of economies in this region. In early 2004 the EBRD extended a €13.1 million loan to Frikom to help improve production facilities, upgrade irrigation systems to produce more raw materials from its own land, and help the company expand its operations into neighbouring countries.

Bulgaria, although not as high as might be expected given its importance in terms of balance of payments revenues to those countries. Tourism activities are still largely controlled by domestic entrepreneurs, partly because privatisation was mostly done through management buy-outs in the early years of transition.

<sup>8</sup> The tables do not include Serbia and Montenegro due to the unavailability of comparable stock data.

<sup>9</sup> See Resmini (2000).

<sup>10</sup> Part of the production is then re-exported to EU markets, therefore reinforcing the trade links between SEE and the EU, as described in more detail in Chapter 5.

<sup>11</sup> Studies on FDI in transition economies at sectoral level have revealed that EU investors are mainly present in traditional sectors while non-EU investors are concentrated in high-tech sectors: see Resmini (2000).



Table 4.2 also shows that there is little or no foreign investment in the agriculture sector, even though it accounts for a significant share of GDP of most SEE countries.<sup>12</sup> Lack of restructuring, uncertainty over the property rights on land, and poor quality infrastructure are among the key deterrents to much-needed foreign investment in this sector.

### 4.3 Prospects for the future

How can the SEE region attract more FDI over the medium term? Improving the investment climate is necessary, as Chapter 2 highlighted, but will not be enough. Foreign investors will want to know whether there are good investment opportunities; whether an investment in one country opens up greater access to others; and whether the region is really competitive relative to the alternatives over the medium term.

### Privatisation

Privatisation has been the main channel for FDI in SEE. Successful large-scale privatisations provide revenues to government and relieve the burden of losses; they can also offer encouragement and guidance for successful restructuring. The Sidex deal in Romania is an example of this (see Box 4.3). In general, FDI inflows to the SEE region are still driven largely by big sales of state assets – in contrast to CEB, where the large-scale privatisation process is nearing completion and the majority of FDI inflows take the form of greenfield or brownfield (i.e. investment in an existing, privately owned company) investment.

The close link between FDI inflows and privatisations in SEE is illustrated in Chart 4.6. The annual changes in gross FDI inflows to SEE and in privatisation revenues<sup>13</sup> have moved in the same direction over time, except in 1999 when FDI fell slightly but privatisation revenues remained buoyant due to several large transactions in the region.<sup>14</sup> However, large-scale privatisation is nearing completion in some countries (see Chapter 2). In a few cases, only the energy and telecommunications sectors are likely to attract sizeable

### Box 4.3

#### Privatisation and FDI: the case of Sidex

In July 2001 the Romanian Authority for the Privatisation and Administration of the State Shareholdings (APAPS) and the multinational company LNM Holdings signed a contract for the privatisation of Sidex, the largest steel mill in Romania accounting for about 4 per cent of the country's industrial production. LNM Holdings is part of the LNM group, the second-largest steel producer in the world. In exchange for approximately 90 per cent of Sidex's share capital, LNM paid US\$ 75 million and pledged to invest over US\$ 350 million in the company over the next decade, including US\$ 76 million to bring Sidex production in line with international environment standards. Under the contract, LNM agreed to maintain employment levels for five years and to keep labour costs fixed almost at existing levels in dollar terms, in return for concessions from the government related to profit tax, VAT and custom duties exemptions.

The privatisation of the company was widely regarded as a milestone in Romania's economic reforms, because Sidex had been a loss-making company for years and was the biggest single

budget drain for the Romanian government. Not only has the restructuring of the company already played an important role in the economic transition in Romania, but it also represents a critical step for the steel industry of central and south-eastern Europe, where progress in restructuring has generally been slow.

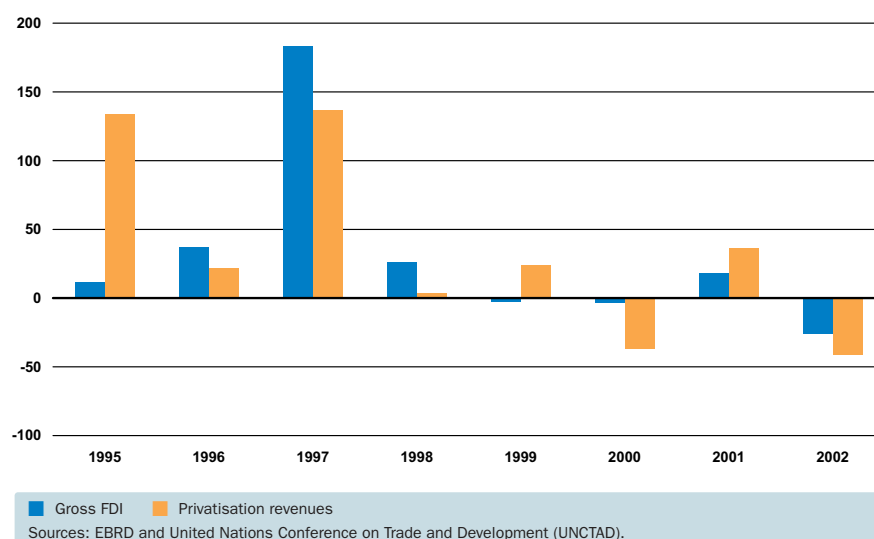
In November 2001 the EBRD provided LNM Holdings with a one-year US\$ 100 million loan facility to support the restructuring of Sidex. This short-term facility provided essential liquidity to improve the company's core business, eliminate barter trade and reverse increasing annual losses. The EBRD has since rolled over its one-year loan into a long-term corporate loan for Sidex's working capital needs and capital expenditures.<sup>1</sup> This will finance an upgrade of production facilities and an improvement in operational efficiency and product quality, turning Sidex into a profitable and competitive steel maker.

<sup>1</sup> A portion of this longer-term loan is being syndicated.

Chart 4.6

#### Gross FDI inflows and privatisation revenues in SEE, 1995-2002

Annual percentage change



investment from abroad, while the banking system is already concentrated in foreign hands. Increasingly, the region will have to focus on greenfield investors.

### Greenfield investment

There are several reasons why foreign companies might want to invest in a country.<sup>15</sup> FDI may be motivated by “market-

<sup>12</sup> See Chapter 4 in the EBRD *Transition Report* (2002).

<sup>13</sup> This chart uses gross FDI inflows to examine FDI from an investment perspective rather than simply a net financing or saving-investment perspective. With the exception of Croatia, which undertakes significant outward FDI, this distinction does not significantly alter the FDI data for most of the SEE countries (see EBRD, 2003a, Box 2.1 for more details).

<sup>14</sup> The degree of co-movement, as measured by the correlation coefficient between these two variables, is significant and much higher for SEE countries (0.68) than for CEB (0.49).

<sup>15</sup> The discussion in this paragraph draws on the influential work of Dunning (1974, 1980).

Table 4.3

## Average monthly earnings and corporate and social security tax rates in SEE and selected CEB countries in 2002-03

	Albania	Bosnia and Herzegovina <sup>1</sup>	Bulgaria	Croatia	FYR Macedonia	Moldova	Romania	Serbia and Montenegro <sup>2</sup>	Czech Republic	Hungary	Poland	Slovak Republic
Gross average monthly earnings in the economy in 2002 (in US\$)	156	263	128	682	175	53	165	135	483	475	418	298
Corporate tax rates in 2003 (in per cent)	25	30, 10	23.50	20	15	22	25	14, 15-25	31	18	27	25
Social security rates paid by the employer in 2003 (in per cent)	31.70	11.50, na	32.20	16.60	32	na	41-48 <sup>2</sup>	16.30, na	35	29	19.8-22.7 <sup>4</sup> 3.5-6.4	38
Social security rates paid by the employee in 2003 (in per cent)	10.20	32, 52	10.50	20.60	na	na	19.67	16.30, na	12.50	11.50	18.71	12.80

Sources: Bulgaria Economic Forum (2004), EBRD survey of national authorities, KPMG tax survey and World Investment Report - UNCTAD (2003).

<sup>1</sup> The first tax rate reported in this column refers to the Federation of Bosnia and Herzegovina, while the second refers to Republika Srpska.

<sup>2</sup> Social security rates paid by the employer vary within the indicated range depending on the work category of the employee.

<sup>3</sup> The first tax rate reported in this column refers to Serbia, while the second refers to Montenegro.

<sup>4</sup> Reduced social security rates are applicable for that part of the income that is over PLN 65,850.

seeking" considerations, either because the size of the recipient country is large and domestic demand is growing rapidly, or because trade barriers impede direct access to its markets. In the latter case, the establishment of a foreign affiliate would allow the investor firm to sell directly to the targeted market, therefore overcoming existing trade restrictions. This is commonly known as horizontal FDI. Vertical FDI may instead be motivated by "efficiency-seeking" reasons, where a firm invests in a foreign country in order to exploit the comparative advantage of the recipient country, typically in the form of lower unit labour costs or better infrastructure. In addition, a country's natural resources may also attract sizable FDI flows.

The "market-seeking" argument is supported by several studies, based on evidence from around the world. There appears to be a significant link between the size of the host country, as measured by that country's GDP, and FDI inflows.<sup>16</sup> However, most markets in SEE are, by themselves, quite small. This is where regional integration agreements (RIAs) can play an important incentive role for FDI, because such schemes increase the effective market size of the recipient country beyond its geographical boundaries.<sup>17</sup> The creation of a free trade area in SEE could, therefore, boost net capital inflows

to the region (see also Chapter 5). The geographic distribution of FDI and trade, however, might become more concentrated, as investors may gather in one particularly investor-friendly location and serve the other countries through free trade.<sup>18</sup>

The effect of greater regional integration on FDI flows within the region is uncertain. If investors were originally motivated by the prospect of avoiding tariff barriers, the creation of a free trade area would tend to discourage further FDI, because existing barriers would then be eliminated. But if FDI is driven, for example, by the desire to integrate different stages of the production process occurring in different locations, then the investment level is likely to rise as transaction costs associated with trade within member countries fall. In fact, the empirical evidence on agreements such as that between the South American countries of Mercosur (i.e. Argentina, Brazil, Paraguay and Uruguay) suggests that FDI inflows do increase from outside sources, while FDI inflows within the region are yet to develop significantly.<sup>19</sup>

In the medium term, the prospects of greater EU integration, and eventual accession, may attract investors from outside the EU, as well as from existing EU member countries. Several studies have shown that an announcement of EU accession progress has a positive effect

on FDI inflows to those countries at an advanced stage of negotiation.<sup>20</sup> Therefore, a further increase in FDI inflows from outside the EU to those SEE countries that have larger domestic markets and better prospects of EU accession can be expected. After accession, these external FDI flows have the potential to increase even further if SEE countries are able to compete with the first wave of accession countries.

### Comparative advantage

In general, SEE countries are not rich in natural resources and some industries have a rather obsolete stock of capital. Their main comparative advantage relative to other emerging markets, in addition to proximity to the main European markets, is labour costs. The data in Table 4.3 show that average earnings in SEE countries are significantly lower than those in selected central European transition countries. With the exception of Croatia, gross average monthly earnings in most SEE economies are about one-third of those in the Czech Republic, Hungary and Poland, and half of those in the Slovak Republic.

Table 4.3 also identifies two other factors that might influence investor decision-making, namely corporate tax rates and social security contributions. The table shows that the corporate tax rate in all the selected transition countries is lower than

<sup>16</sup> See Bevan and Estrin (2003), Garibaldi et al. (2001), EBRD (2003b) and Resmini (2000) among others.

<sup>17</sup> See Dunning (2000), Blomström and Kokko (1997), and Levy Yeyati et al. (2002).

<sup>18</sup> Market size and proximity to core markets are the factors that are likely to influence the relocation decision of multinational companies, and determine which country would gain or lose from this redistribution.

<sup>19</sup> See Blomström and Kokko (1997) and Levy Yeyati et al. (2002).

<sup>20</sup> See Bevan and Estrin (2003).

the EU average rate of 32 per cent.<sup>21</sup>

Nonetheless, there is a high variation in the tax treatment of profits within the region. The corporate tax rate in Croatia, FYR Macedonia, and Serbia and Montenegro is at or below 20 per cent, significantly less than the average corporate tax rates in Poland or the Czech Republic. Some countries, like Bulgaria, are considering further cuts in corporate tax rates, to increase their attractiveness to foreign investors and to reduce the size of the informal sector.

Employers' social security contribution rates in SEE are generally high – usually more than 30 per cent – adding considerably to the cost of labour. The average tax rates paid by employees vary between 10 and 20 per cent, depending on the country and the degree of reform of its social security system. Within SEE, Croatia and Serbia seem to be best placed in this regard to compete for investment capital. However, the fact that in 2003 Hungary had among the lowest corporate and social security tax rates in either CEB or SEE did not prevent net FDI inflows from falling sharply that year. Competitive tax rates are not sufficient to attract foreign investors; macroeconomic stability, progress in structural and institutional reforms, the presence of a well-developed infrastructure network and the quality of the investment climate are also important factors.

## 4.4 Conclusions

The analysis in this chapter shows that SEE is now a significant destination for foreign capital, most of which comes from private sources. FDI inflows to SEE are more stable than other types of capital and have increased steadily to reach an estimated peak of over US\$ 6 billion in 2003. International bank lending has also risen in recent years while portfolio inflows remain limited. EU countries such as Italy, Germany, Austria and Greece are among the top five investors in SEE. Intra-regional FDI is also starting to expand. Most FDI in SEE is concentrated in banking, the manufacturing and general industry sectors.

So far, FDI has been driven mainly by large-scale privatisation deals. The key challenge will be to attract increasing inflows of greenfield FDI. Market size will be crucial, and can be increased effectively by further regional integration and the removal of trade barriers. A cheap and productive labour force is a significant attraction of the region, while corporate tax rates are also competitive relative to other transition countries. Nevertheless, attracting sustainable FDI depends crucially on other factors such as economic and political stability, progress in reforms and improvements in countries' investment climate.

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<sup>21</sup> See UNCTAD (2003).



# Cross-border trade and access to regional and EU markets

# 5

Access to international markets is vital for all countries in SEE. Individually, the economies of the region are small when compared with the large western European countries. Openness to trade and economic growth are closely linked, especially for small countries.<sup>1</sup> Greater openness also enhances the level of foreign direct investment, as the previous chapter demonstrated. Many investors want to sell the goods produced by the enterprises that they acquire in “local” markets. The larger those markets are, the better. Openness to trade helps to convert small markets to bigger ones, making many investment prospects and locations look more attractive than they might at first appear.

During the transition, enterprises in SEE have found it difficult to reach markets abroad for several reasons. In all transition countries it has taken time for businesses to make new contacts, acquire new marketing skills and convince clients abroad that they will be reliable partners. Other problems, however, are more specific to SEE, and especially those countries that were part of the former Socialist Federal Republic of Yugoslavia (SFRY). The break-up of the SFRY and the subsequent conflicts of the 1990s had a devastating effect on trade relations in the whole region.

The situation has improved in recent years. Expanding trade has become a priority of all governments in the region. Countries are now cooperating on trade relations to an extent that would have been hard to imagine even in the late 1990s. The EU has helped significantly by lowering barriers and opening up markets to all countries in SEE, not just to those in the accession process. In fact, barriers to trade from the EU are, according to some measures, lower for SEE countries than they are for the accession countries of CEB. However, measures by governments to expand trade are not enough on their own. Ultimately, it is the

**Table 5.1**

**Trade in south-eastern Europe, 1980-85 (in per cent of total)**

	Bulgaria	Romania	Socialist Federal Republic of Yugoslavia
Exports to other SEE countries	3.8	1.4	2.7
Imports from other SEE countries	3.0	1.7	1.0
Main trading partner - exports	Soviet Union 49.9	Soviet Union 18.1	Soviet Union 30.5
Main trading partner - imports	Soviet Union 57.3	Soviet Union 18.2	Soviet Union 15.5

Source: Vienna Institute for International Economic Studies (WIIW).

Note: The table give the percentage of exports (imports) that go to (from) the other SEE countries and the main trading partner at that time. Data for Albania and Moldova were not available.

response of the private sector to new opportunities that matters. This response has been sluggish. Trade flows, especially within the region, are still below their potential, suggesting that there is scope for direct action to promote trade even further.

This chapter examines the current environment for trade in SEE, and the extent of access to outside markets and regional cooperation. Having outlined the structure of trade flows within and outside the region, it gives an overview of the current degree of trade liberalisation.

The chapter then discusses the low level of trade within the region and externally, offering three possible explanations: restrictive access to EU markets; invisible non-tariff barriers and other obstacles to trade; and the understatement of the true level of trade in official trade statistics. The chapter goes on to examine initiatives to expand trade opportunities – including moves towards a regional free trade market, enhanced integration efforts with the EU, and the expansion of regional trade guarantee facilities – before concluding with a summary of key points.

## 5.1 Structure of intra-regional and inter-regional trade

### Intra-regional trade before and after the break-up of Yugoslavia

Trade relations in SEE have always been fragmented. Unlike central Europe, trade in SEE was traditionally oriented towards “local” markets, in particular among Yugoslav republics on one side and the eastern Balkan countries on the other.<sup>2</sup> Albania was for many years quite isolated, with minimal levels of trade either within or outside the region, while Moldova was part of the internal Soviet Union market. In addition, the difficult geographical terrain and poor quality of infrastructure of the region have been, and remain, significant barriers to trade.

As a result of these factors, SEE was not fully integrated even during the times of relative prosperity (at least in the SFRY) in the 1970s and 1980s. As Table 5.1 shows, trade between the countries of SEE in the first half of the 1980s was fairly limited, with much more trade going to and from the former Soviet Union.

<sup>1</sup> On the relation between trade and growth, see Frankel and Romer (1999), EBRD (1994, Section 7), Brenton et al. (1999), Estrin et al. (2003), and Garibaldi et al. (2001).

<sup>2</sup> See, for example, Gilgorov et al. (2001, 2003).

Table 5.2

**Trade between former Yugoslav republics, 1987 and 2000 (in per cent)**

	Exports to Yugoslav republics 1987	Other exports 1987	Exports to former Yugoslav republics 2000	Other exports 2000
Bosnia and Herzegovina	55	45	34	66
Croatia	57	43	26	75
FYR Macedonia	55	45	27	74
Montenegro	59	41	na	na
Serbia	46	54	29	71
Slovenia	48	52	14	86
<i>Unweighted average</i>	<i>53.3</i>	<i>46.7</i>	<i>26.0</i>	<i>74.4</i>

Source: World Bank (2003, Table 2.6).

Table 5.3

**Share of trade in GDP, 2002 (in per cent)**

Albania	Bosnia and Herzegovina	Bulgaria	Croatia	FRY Macedonia	Moldova	Romania	Serbia and Montenegro
37.6	80.5	82.1	68.2	79.3	106.4	66.9	55.8
Czech Republic	Estonia	Hungary	Latvia	Lithuania	Poland	Slovakia Republic	Slovenia
113.2	125.1	108.9	78.5	97.2	40.5	130.3	96.3

Note: Share of trade represents the sum of exports and imports divided by GDP.

Source: EBRD (2003).

The greatest changes in trade patterns have happened in former Yugoslavia. Table 5.2 compares the export trade of the former Yugoslav republics in 1987 (prior to the break-up of the SFRY) with their export trade in 2000 as independent states.<sup>3</sup> In 1987 most republics exported more than half of their goods to other Yugoslav republics, but by 2000 this had fallen to less than one-third in most cases. Nevertheless, some countries of the former Yugoslavia have maintained, and even increased, the share of trade with other former republics (see below).

**Trade patterns**

How do SEE countries compare with other countries in terms of openness to trade? One method of measuring openness in a given year is to calculate the sum of exports and imports and divide it by GDP.

Table 5.3 gives the results of these calculations for each country in SEE and CEB for 2002.

The table shows that, for most countries, the ratio of exports and imports to GDP (expressed as a percentage) is between 60 and 90 per cent. Moldova, which has by far the lowest GDP of all eight SEE countries, has an openness ratio of a little over 100 per cent. In contrast, Albania's ratio is below 40 per cent, mainly because exports are low (the trade deficit in 2002 was 24 per cent of GDP).<sup>4</sup> Table 5.3 also shows that in CEB countries acceding to the EU in May 2004, the openness ratio is usually higher.<sup>5</sup> Judging by the trade deficit figures mentioned in Chapter 1, it is the depressed level of exports, rather than imports, that mainly accounts for the low measures of openness in SEE.

The difference in openness between SEE and the accession countries is even larger if GDP is measured in purchasing power parity terms rather than at market exchange rates.<sup>6</sup> If this adjustment is made, SEE's level of openness (based on an unweighted average of countries in the region) is only about half the level of openness in the eight accession countries of CEB, and considerably less than half the openness of the EU.<sup>7</sup>

An interesting feature of trade in SEE is that flows of goods within the region are low compared with those between SEE and the EU. Charts 5.1 and 5.2, for exports and imports respectively, show the percentage of trade in 2002 for each SEE country for both inter- and intra-regional trade. The charts show that the EU is generally the main destination for exports from, and the main source of imports to, the SEE region. For most countries, about half of exports go to the EU, although the figure is particularly large for Albania (almost 90 per cent), Serbia and Montenegro (about 80 per cent) and Romania (about 67 per cent). Only Moldova has a relatively low share of exports to the EU, at just over one-quarter.

Geographical and cultural proximity are key determinants of trade and investment flows.<sup>8</sup> A breakdown of exports by country of destination shows that Italy is the main recipient of exports from six countries in the SEE region. Albania, for example, sent about 65 per cent of its total exports to Italy in 2002 and has received from that country about half of its total inward stock of FDI (see Chapter 4); this highlights the importance of distance and transportation costs as determinants of a country's trade orientation and investment flows (see also below).

Data show that not only is intra-regional trade limited, but bilateral trade within the region is sometimes very low, surprisingly so given the geographic proximity of some countries. There is virtually no trade, for example, between Bosnia and Herzegovina and Albania. In fact, Albania's level of

<sup>3</sup> This table is drawn from World Bank (2003).<sup>4</sup> See EBRD (2003).<sup>5</sup> The exception is Poland, which has by far the largest economy in CEB and is therefore not directly comparable.<sup>6</sup> See EBRD (2003, Chapter 4) and Babetskii et al. (2003).<sup>7</sup> See EBRD (2003, Chapter 4, Chart 4.1). Note that the calculations in this chart are based on a definition of SEE that excludes Moldova. The small size of Moldova means that the conclusion would not change significantly if it were included.<sup>8</sup> See, for example, Resmini (2000) and Basu et al. (2003).

exports in 2002 to the other seven countries was less than US\$ 20 million (about 2 per cent of the total). Moldova has very little trade with most other SEE countries (excluding Romania), due to weak existing economic relations and lack of previous historical and cultural ties.

Another example of low bilateral trade is Bulgaria and Romania. In 2002 Romania's exports to Bulgaria were valued at around US\$ 176 million, out of a total of nearly US\$ 13.9 billion, while Bulgaria's were less than US\$ 160 million (out of US\$ 5.6 billion).<sup>9</sup> This can be partly explained by the poor infrastructure links between the two countries (with only one bridge over the River Danube linking the two countries) and by the similarity of many of the goods produced by each country.

Table 5.4 shows the main products that are exported and imported by SEE countries as a percentage of total trade. Typical export products are textiles, miscellaneous manufacturing goods, food and beverages. These sectors are labour-intensive, with lower unit labour costs compared with other parts of central Europe, as described in Chapter 4. Consequently, they have attracted significant FDI inflows, mainly from neighbouring EU countries such as Italy and Germany. Cost-saving and efficiency considerations have partly driven the decision by foreign multinational companies to relocate their production activities to SEE countries. The link between FDI and trade flows arises naturally, as most of these multinationals re-export the finished goods to their home countries. Table 5.4 also shows that machinery and electronic equipment, together with mineral products, are the main categories imported by SEE countries. This is not surprising, as these industries have often inherited an obsolete capital stock from the communist era.

### Actual and predicted trade

The data above give a useful picture of trade relations within the SEE region and with the rest of the world. However, they do not show the extent to which trade in the region falls below the levels that would be expected given the usual pattern of intra-regional trading around the world.

Chart 5.1

#### Percentage of exports to other SEE countries, the EU and the rest of the world, 2002

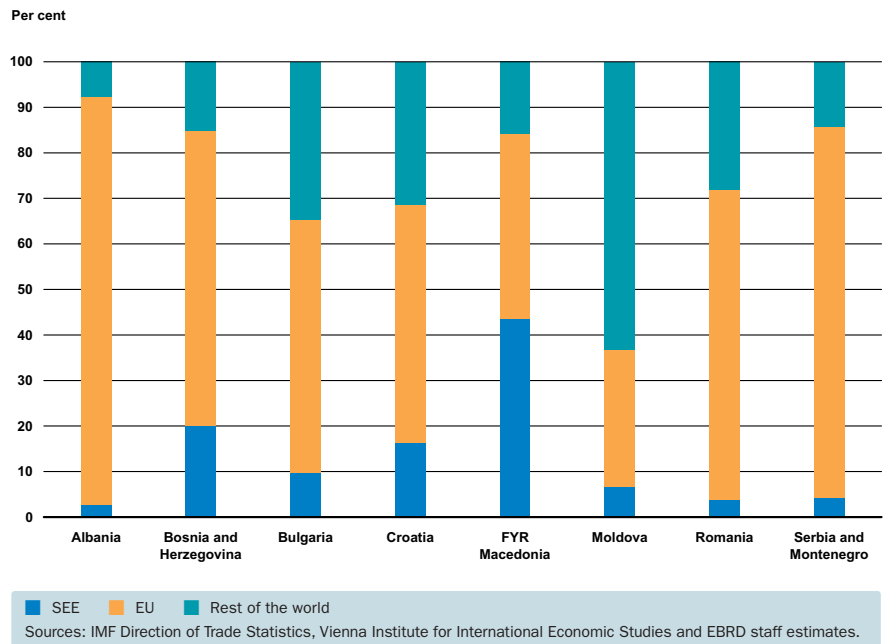
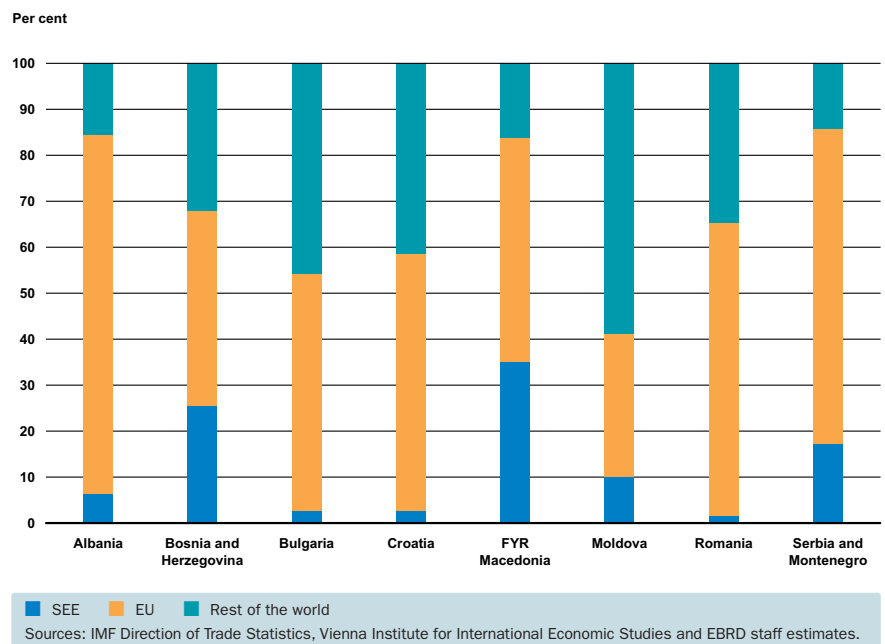


Chart 5.2

#### Percentage of imports from other SEE countries, the EU and the rest of the world, 2002



This issue has been addressed in several studies correlating trade between two countries with the relative size of the two economies and with the distance between them (using a "gravity model"). One study estimates a gravity model for a range of

Organisation for Economic Cooperation and Development (OECD) countries and transition countries, using data for 1996-99.<sup>10</sup> The results relating to intra-regional trade flows largely confirm that some countries trade with each other more than

<sup>9</sup> These data are from the Romanian national statistical office and the Bulgarian National Bank.

<sup>10</sup> See Christie (2002).

Table 5.4

## Leading imports and exports, 2001

	Albania	Bulgaria	Croatia	FYR Macedonia	Moldova	Romania	Serbia and Montenegro
<b>Export</b>	Manufacturing articles	Clothing and footwear	Other machines and transport equipment	Manufacturing goods	Food, alcohol, tobacco	Textile and textile products	Products classified by materials
<i>Percentage of Exports</i>	68.30	20.00	20.75	32.40	44.10	26.20	34.30
<b>Import</b>	Machinery and transport equipment	Textiles	Other machines and transport equipment	Unclassified goods	Mineral products	Machinery, appliances and electrical equipment	Machines and transport
<i>Percentage of Imports</i>	24.30	10.00	20.75	27.70	27.10	22.70	21.30

Sources: IMF, various staff reports, CIS Statistical Committee and EBRD staff estimates. Data for Bosnia and Herzegovina were not available.

would be predicted by the model, while others trade far less. Examples of the former are trade between Bosnia and Herzegovina and Croatia, Bosnia and Herzegovina and Serbia and Montenegro, and FYR Macedonia and Serbia and Montenegro; the latter includes Croatia and Serbia and Montenegro, and Albania with most other countries of the region.

Similar results are found in a World Bank study that focuses primarily on the western Balkans.<sup>11</sup> It concludes that the potential for expanded intra-regional trade among the countries of former Yugoslavia is quite limited, although the results may be unreliable due to the problem of unrecorded trade (see below). The study adds that an exception to this conclusion is the level of trade between Croatia and Serbia and Montenegro, where the removal of existing trade barriers might be expected to lead to significant growth of bilateral trade. It also notes the “exceptionally low” level of Romania’s trade with the rest of the region.

The ratio of actual to predicted trade in SEE (excluding Moldova), taking into account additional factors such as the number of borders to cross, the quality of infrastructure and institutions and the extent of trade liberalisation, is examined comprehensively in Chapter 4 of the EBRD *Transition Report* (2003) and in a companion paper by some of the authors.<sup>12</sup> This analysis, using 1995-

2002 data, brings out the importance of institutions as a determinant of trade in transition countries. As noted earlier in Chapter 2, institutional reform is an area where the region has lagged behind, and where improvements could see further rewards in terms of expanded trade opportunities.

## 5.2 Trade liberalisation

This section examines whether there is scope for further liberalisation of trade regimes in SEE. The countries of SEE typically appear to have very liberal trade regimes, and in some ways more so than those in EU countries. However, in reality, many unwritten trade restrictions still exist. Once other informal or non-tariff obstacles are taken into account, it is clear that there is much scope for further liberalisation.

There are two ways of measuring the degree of trade liberalisation. The first draws on the EBRD transition indicators, in this case the index of trade and foreign exchange liberalisation.<sup>13</sup> The second indicator is the IMF’s Trade Restrictiveness Index (TRI), which classifies countries according to how restrictive their trade regimes are.<sup>14</sup>

Table 5.5 contains the indexes. The first row shows that five countries have achieved the highest rating (4+) on the EBRD score, with the others close behind.

The second and third rows contain two IMF indexes: one for non-tariff barriers and one for an overall trade restrictiveness rating. Countries in the region again score highly on trade liberalisation measures according to IMF criteria. In fact, most achieve a better score than EU countries, because the latter impose significant tariffs on many goods from outside the EU. These indexes show that, for most countries in SEE, there is little more that most of them can do in terms of harmonising customs duties or removing quantitative and administrative barriers on exports and imports.

In addition, the fourth row of Table 5.5 shows that six countries are WTO members (FYR Macedonia being the most recent to join in April 2003). Bosnia and Herzegovina and Serbia and Montenegro have applied for accession, but membership is unlikely before 2005 at the earliest. Being part of the WTO brings a number of benefits to countries, including most favoured nation (MFN) privileges.<sup>15</sup> Also, the EU is committed to ensuring that agreements signed with SEE, whether Partnership Agreements or Stabilisation and Association Agreements, are compatible with WTO regulations and in line with the respective Partnership Agreements that individual countries of the region have with the EU.<sup>16</sup>

<sup>11</sup> See World Bank (2003).

<sup>12</sup> For the companion paper, see Babetskii et al. (2003).

<sup>13</sup> For this indicator, a score of 1 means widespread import and/or export controls and little access to foreign exchange, while 4+ implies standards comparable to advanced industrial countries, the removal of most tariff barriers and membership of the World Trade Organization. For details, see EBRD (2003, Chapter 2).

<sup>14</sup> The scale of trade openness ranks countries from 1 (completely open) to 10 (completely closed). For an application that uses these indexes, see Babetskii et al. (2003).

<sup>15</sup> For an explanation of what MFN implies, and more details, see [http://www.wto.org/english/tratop\\_e/serv\\_e/guide1\\_e.htm](http://www.wto.org/english/tratop_e/serv_e/guide1_e.htm).

<sup>16</sup> See European Commission (2002).

In conclusion, countries in the region have gone a long way towards implementing standard trade liberalisation measures. The next section looks at alternative reasons why trade within and outside the region has not yet reached its potential.

### 5.3 Constraints on trade

Many reasons have been put forward to explain the low level of both intra- and inter-regional trade in SEE. It has been argued that the region has trouble trading with the EU and other advanced OECD countries because of high tariff protection towards goods in which the region has a comparative advantage. Another explanation focuses on non-tariff barriers, such as onerous licensing requirements for exports and imports, corruption at border crossings and poor transport connections. A third possibility is that the official trade statistics are seriously under-recorded and do not account for informal cross-border trade and smuggling. These issues are examined in turn.

#### Barriers from external regions

The EU is by far the most important trading partner for SEE countries. It is therefore the most relevant trading bloc to study in assessing how much tariff protection the region faces in the wider world. Trade relations with the EU range from pre-accession agreements with Romania and Bulgaria (which include bilateral free trade on industrial products) to the series of cooperation agreements with other SEE countries.

EU trade policy towards SEE countries has evolved steadily towards greater cooperation and integration, with a commitment to the promotion of open and fair trade with all trading partners, irrespective of their prospects of EU membership. The SEE region has benefited in particular through a series of preferential bilateral trade agreements. These are “asymmetric”, meaning that, for a transition period, SEE countries are allowed to impose higher tariffs on imports from the EU than those imposed on similar goods that they export to the EU. For the western Balkans, the EU has, since September 2000, removed customs duties on 95 per cent of

Table 5.5

#### Indexes of trade restrictiveness

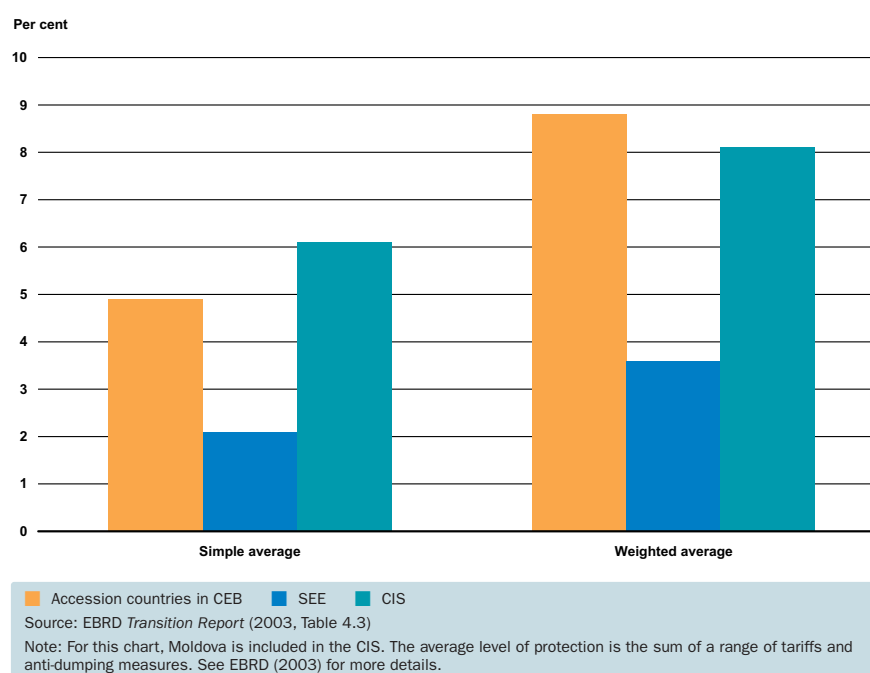
	Albania	Bosnia and Herzegovina	Bulgaria	Croatia	FYR Macedonia	Moldova	Romania	Serbia and Montenegro
EBRD transition indicator	4+	4-	4+	4+	4+	4+	4	3+
IMF NTB rating (2002)	1	1	1	1	1	1	1	2
IMF Overall rating (2002)	1	1	2	1	2	1	3	5
WTO membership	yes	no	yes	yes	yes	yes	yes	no

Source: IMF staff estimates, WTO and EBRD (2003).

Note: The EBRD transition indicator ranges from 1 to 4+, with 1 representing limited progress towards trade or foreign exchange liberalisation and 4+ representing the removal of most tariff barriers and membership in the WTO. The IMF indexes are for non-tariff barrier (NTB) restrictions and overall restrictiveness, with a range from 1 (most liberal) to 10 (most restrictive). The IMF overall restrictiveness rating for each EU country is 4.

Chart 5.3

#### Average level of protection of EU against transition countries



exports from these countries. To provide conformity, these bilateral trade agreements are compliant with WTO rules.<sup>17</sup>

In fact, SEE countries generally face a more favourable tariff regime than other transition countries do, as the analysis in Chapter 4 of the EBRD Transition Report (2003) shows.<sup>18</sup> Chart 5.3 illustrates that average tariff protection from the EU, on an unweighted basis, is 2.1 per cent for SEE, compared with 4.9 per cent for CEB and 6.1 per cent for the CIS. The same broad

conclusions emerge even when a weighted average is taken.<sup>19</sup> The fact that, on these measures, SEE faces lower protection than CEB accession countries is an indication of the importance the EU attaches to expanding trade and integration with SEE.

Two cautionary points should be noted. While the average may be low, some SEE goods face quite high tariffs, and it is often those goods (such as textiles, metals and agricultural products) in which many countries of the region specialise.

<sup>17</sup> For more information on GATT (General Agreement on Tariffs and Trade) and GATS (General Agreement on Trade in Services), see the WTO web site: <http://www.wto.org>.

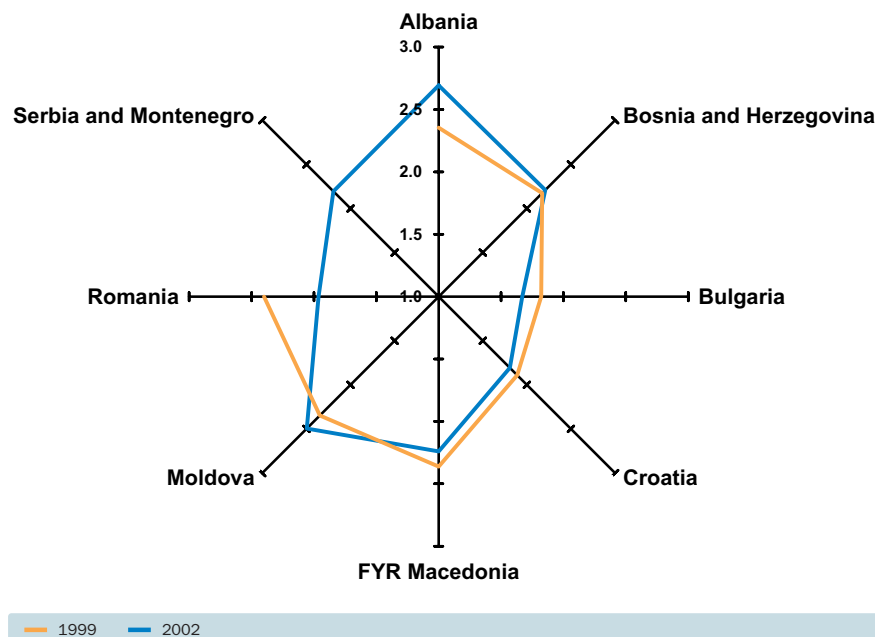
<sup>18</sup> See EBRD (2003).

<sup>19</sup> The weights take account of a sector's importance for trade, as represented by export volumes to the EU. In order to control for the effect of high tariffs on actual trade, the weights used are based on EU imports from a group of countries with similar levels of GDP per capita. For more details, see EBRD (2003, Chapter 4).



Chart 5.4

## Average rating for obstacles posed by customs and trade regulations



Source: Business Environment and Enterprise Performance Survey (BEEPS), 1999 and 2002.

Note: The rating for obstacles posed by customs and trade regulations is a score from 1 to 4, with 1 representing a minor obstacle and 4 representing a major obstacle. The scores are averaged across all enterprises within each country. Serbia and Montenegro was not included in the 1999 BEEPS.

Calculations from Chapter 4 of the EBRD *Transition Report* (2003) show that the average rate of protection imposed by the EU on the region would decline by almost 44 per cent if all tariff rates were capped at 15 per cent. The percentage reductions in CEB and the CIS, if similarly capped, would be 34.3 and 20.2 per cent respectively. While most of SEE will continue to face a relatively benign trading environment in the EU, opportunities in some key sectors will be limited until these high rates are reduced.<sup>20</sup>

The second point is that requirements related to rules of origin (to determine who should benefit from tariff-free or low tariff access) are often stringent and difficult for countries to observe.<sup>21</sup> The EU imposes these requirements to stop countries with which it does not have trade agreements (or with which it has less generous agreements) diverting their trade through countries with which the EU does have agreements in order to benefit from

reduced or zero tariffs. When a product goes through multiple stages of production, as do most textile products for example, it is often the case that all stages must be carried out in the beneficiary (free trade) country, otherwise the final product does not qualify for the zero or reduced tariff rate. The administrative cost and complexity of proving origin at each stage and for different inputs are often onerous. As a result, access to EU markets may be more complicated for businesses in the region than a simple glance at tariff rates might suggest.

### Infrastructure and non-tariff barriers

Most tariff barriers to SEE trade have been, or are being, removed. However, several studies show that the main obstacles to trade within the region are non-tariff related.<sup>22</sup> These include quantitative restrictions, governments' restrictive practices, customs procedures and technical barriers to trade. Often, such

measures are used to discriminate in favour of domestic firms.<sup>23</sup> However, governments sometimes have legitimate reasons to keep out imports – for example, for environmental or health protection reasons.

Low-quality infrastructure and excessive regulations are two of the biggest barriers to trade in SEE. The poor state of transport infrastructure in the region, and the physical difficulties in moving goods from one country to an adjacent one, are highlighted in a recent report – the *Regional Balkans Infrastructure Study: Transport* (REBIS).<sup>24</sup> This study found that “over 70 per cent of the roads [in the region] are in need of some form of pavement renewal” and that, in the railway sector, “most lines need modernisation” and “only 10 per cent [of the network] is classified as being in good condition”. It also drew attention to the long delays at customs and the need for physical improvements to some border crossings.

For the five western Balkan countries in the Stabilisation and Association process, a study of the practice of non-tariff barriers has shown that, while the situation has varied from one country to another, major problems exist across the region in the areas of licensing, customs valuation, the functioning of customs, and technical barriers to trade,<sup>25</sup> although the survey recognises that the situation is fast-changing.

The Business Environment and Enterprise Performance Survey (BEEPS) also highlights the problem of regulations throughout the region. It asks enterprises whether customs and trade regulations are an obstacle to their operations and growth. As with other BEEPS questions analysed in Chapters 2 and 3, the answer scale ranges from 1 (no problem) to 4 (major problem). Chart 5.4 shows that in this area, there appears to have been little or no progress between 1999 and 2002. Only Romania seems to show a significant improvement, while the situation may even have deteriorated in Albania and Moldova. More than one-third

<sup>20</sup> The tariff regime for certain goods is under constant review. For example, the EU and Serbia and Montenegro launched negotiations in late 2003 on a new textile agreement. See <http://www.eudelyug.org/en/news/news/final20030808/final20030808.htm> for more details.

<sup>21</sup> This point and the subsequent discussion draw on Brenton and Manchin (2002).

<sup>22</sup> See, for example, Stability Pact (2003) and Gligorov et al. (2003). For an overview of non-tariff barriers, see OECD (2003).

<sup>23</sup> See UNCTAD (2001).

<sup>24</sup> The final report was published by the European Commission in July 2003. The project was funded by the European Union under the 2000 Community Assistance for Reconstruction, Development and Stabilisation (CARDS) programme.

<sup>25</sup> See Tschäni and Wiedmer (2001).



of respondents in Albania, and about a quarter in Moldova, said that customs and trade regulation were a major problem in 2002.

The removal of non-tariff barriers is generally the responsibility of individual SEE countries. However, they might be tackled more effectively through the legal requirements of multilateral systems such as the WTO and regional trade agreements. This is another reason why Bosnia and Herzegovina and Serbia and Montenegro can benefit from future membership.

### Unrecorded trade

Official trade data for SEE are unreliable. It is an ideal region for people who wish to trade illegally outside the scrutiny of the legitimate authorities, since many border areas between countries are not policed effectively. The recent history of the region – particularly the violent break-up of the SFRY and consequent international sanctions – led to a high degree of smuggling, as state and private enterprises, especially in Serbia and Montenegro, sought ways to circumvent trade restrictions.

The degree of unrecorded trade is, by its very nature, impossible to measure with any accuracy. Nevertheless, such non-visible trade is integral to the informal sector which, as Chapter 2 described, seems to be highly significant throughout most of SEE. The results from the BEEPS and other surveys, noted earlier in Chapter 2, show why enterprises have an incentive to evade cumbersome and corruptible legal requirements for conducting trade.

The World Bank notes that trade statistics for Serbia and Montenegro are particularly unreliable, since the extent of trade relations with some countries is unknown and trade through Montenegro and Kosovo is especially likely to be unrecorded.<sup>26</sup> The same study notes that, in several cases, there are huge differences within the region between export figures from one country to another and the corresponding flow of imports. These variations cannot be explained simply by differences in valuation or costs of insurance and freight.<sup>27</sup>

### Box 5.1

#### The SEE regional electricity market

Energy is a key sector in all SEE countries and one where the benefits from enhanced trade are immediately apparent. A regional approach to energy supply can offer significant benefits in terms of improved utilisation of existing supply and production capacities, and it can help to ensure that the region makes the best use of future investments. The EU, with support from bilateral donors and IFIs, is encouraging intra-regional cooperation in this area, including the development of the South-East Europe Regional Electricity Market (SEEREM). A Memorandum of Understanding (MoU) was signed by countries in the region (along with Greece and Turkey, with Hungary and Italy as observers) in Athens in November 2002. Among other things, the MoU called for the establishment of state-level national energy authorities, regulators and transmission system operators; the opening of markets in line with EU commitments (with a

suitable transition period); the unbundling of integrated utilities; and the introduction of an anti-corruption programme in the sector.

In 2003 a revised MoU was signed which, among other provisions, included the gas sector. The intention is to transform the MoU into a legally binding international agreement, including the establishment of independent electricity regulatory agencies, by mid-2005. The process set out in the Athens MoU should result eventually in a transparent, competitive market in the region. However, legal and regulatory advances need to be followed by the development of efficient trading mechanisms, such as spot markets, trading exchanges, clearing houses and credit banks. Efficient trading will also require the physical infrastructure of high voltage connections in the region, for which IFIs (including the EBRD) are providing financing.

Although estimating the size of the informal trading sector is difficult, it is clear that reducing illicit flows would bring benefits to the budget of the government and to competitors in the formal sector.

### 5.4 Recent initiatives to expand trade

SEE should be a prime region for expanded trade, both intra- and inter-regional, over the medium term. The patterns identified earlier in the chapter suggest that opportunities for trade are not being fully exploited, while the discussion on obstacles suggests that these problems, although serious, are not insurmountable. When countries act together much can be achieved, as the recent progress on setting up a regional market for electricity shows (see Box 5.1). Other initiatives to increase SEE trading volumes are examined below.

#### Trade agreements within the region

An important development in trade liberalisation within the region has been the signing of a Memorandum of Understanding (MoU) on free trade in June 2001. The MoU, under the sponsorship of the Stability Pact, aimed to bring about bilateral free trade agreements (FTAs) among all the countries in the region. While a number of countries had similar agreements in place already, such as FYR Macedonia and Serbia

and Montenegro (signed in 1996), enforcement had been patchy and it is not clear that the agreements had any real value in terms of facilitating trade.<sup>28</sup>

The aim of the new initiative was to have in place, by the end of 2002, 21 signed bilateral FTAs among all countries of the region, with the exception of Moldova, which at that time was not a member of the Stability Pact.<sup>29</sup> The network of 21 FTAs was in place by February 2003, although Serbia and Montenegro subsequently requested a revision of agreements with several countries. Bilateral negotiations between Moldova and other countries in the region made good progress during 2003. By February 2004, 26 of the 28 FTAs had been signed (plus one initialled and one still under negotiation), and 16 were already in force.

These FTAs are meant to promote easier trade between the countries of the region and a more attractive business environment for foreign investors. However, more needs to be done to ensure that they conform to the spirit and to the letter of the MoU and that all countries consistently meet their obligations under each FTA. This is likely to require further liberalisation in agricultural products in particular.<sup>30</sup>

<sup>26</sup> See World Bank (2003).

<sup>27</sup> See also Uvalic (2002).

<sup>28</sup> This point is made in World Bank (2003).

<sup>29</sup> Moldova joined this process on a later timetable.

<sup>30</sup> See Stability Pact (2003).

It should also be recognised that the bilateral FTAs are not necessarily compatible with each other. There is still some scope for trade diversion because of different tariff rates and non-tariff barriers in the region, and as long as these barriers remain, investors are unlikely to view the region as one large market. However, a recent review of the progress and implementation of the FTAs found that tariff rates for many goods typically differ by less than five percentage points, and hence the scope for trade diversion was already quite small.<sup>31</sup> Many analysts of the region are now proposing the long-term desirability of alternative solutions, such as a regional free trade area like the Central European Free Trade Area (CEFTA), of which several SEE countries (Bulgaria, Croatia and Romania) are already members.<sup>32</sup>

### Enhanced access to the EU

Although the EU is relatively open to most goods from the SEE region, more can be done, especially for the western Balkans, in terms of granting even greater access. At the Thessaloniki Summit for the Western Balkans in June 2003, the EU endorsed a number of recommendations for enhanced liberalisation of trade with the western Balkans, including further technical assistance to countries of the region. In addition, the EU plans to extend special tariff exemption measures (through the pan-European diagonal cumulation of origin<sup>33</sup>) to SAP countries, although no detailed timetable has yet been proposed.

Many businesses in the region that would like to trade with the wider world face another practical difficulty that has not yet been discussed. By its nature, trade across borders often involves a risk that goods that have been delivered are not paid for, or conversely if pre-payment is required, the exporter may then fail to deliver the goods. Banks can play an intermediary role by providing guarantees. Most banks in the region are understandably reluctant to do so. This creates a gap that, for the time being, can only be filled by export-credit agencies or by bilateral and multilateral

### Box 5.2

#### The EBRD's Trade Facilitation Programme

This programme, which is supported and co-financed by a number of bilateral donor countries (including Switzerland, the Netherlands, Norway, Austria and Germany), provides guarantees to banks for export and import transactions throughout the whole transition region. In SEE all eight countries are benefiting; between 1999 and the end of 2003 more than 1,150 transactions were guaranteed, with a total turnover of nearly €178 million. The programme has particularly helped banks and enterprises in FYR Macedonia and Bosnia and Herzegovina. In the former, for example, it remained open during the security crisis in 2001 when other commercial banks were withdrawing their services because of the increased risks.

To date, most transactions supported under the programme in SEE have been between the region and the outside (mainly the EU). However, the share of intra-regional transactions supported by the programme is increasing. Trade support programmes such as this one not only contribute to the expansion of intra- and inter-regional trade but also promote institutional development by helping local banks to set up cross-national transactions in line with best international practice. They also help local banks to establish contacts and build longer-term relationships with foreign banks.

organisations. Box 5.2 shows how IFIs, such as the EBRD, have attempted to overcome this problem through trade support programmes.

### 5.5 Conclusion

One of the most important conclusions of this chapter is that countries in SEE are becoming more open and trading more, both within the region and with the rest of the world. However, average levels of openness are still well below those in comparable regions around the world, suggesting that unexploited opportunities for further trade enhancement remain. All SEE countries have made significant advances in trade liberalisation, most have abandoned quantitative restrictions on almost all imports and exports, and six of the eight are now WTO members. Reducing non-tariff barriers, including regulations and corruption, and improving transport infrastructure remain the key challenges.

The EU has opened up to the region in recent years and grants tariff-free access across a wide range of goods. Technical barriers to trade, however, need to be reduced further if countries in SEE are to take full advantage of the new opportunities. The proposed extension of the principle of diagonal cumulation could bring significant benefits for the region.

The signing of bilateral free trade agreements among countries of the region is another important advance, and indicative of a new spirit of regional cooperation. These agreements should herald more comprehensive liberalisation and eventually a common free trade area, which in turn should lead to greater competition, productivity and FDI. But many potential cross-border transactions would not take place without targeted trade support measures from bilateral and multilateral organisations, which are enabling enterprises in the region to take advantage of these new opportunities.

<sup>31</sup> See Messerlin and Miroudot (2004).

<sup>32</sup> See, for example, Adam et al. (2003), who use a gravity model to show that regional free trade areas such as CEFTA or the Baltic Free Trade Area (BFTA) have helped to expand regional trade for members of those organisations.

<sup>33</sup> The principle of diagonal cumulation means that the percentages of value added produced in each country can be accumulated for the purposes of determining the origin of a product. According to the World Bank (2003), there would be "significant benefits" to SAP countries if this principle is extended successfully because it could enable them to take advantage of special tariff exemptions that depend on the value added content, while the impact on EU producers would, according to the same study, be "minuscule".

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# Conclusions and policy implications

# 6

This study began by describing south-eastern Europe as a region of opportunity and potential, whose citizens should be able to look forward to a much brighter future after the turmoil of the recent past. However, as subsequent chapters have demonstrated, the development of the region as a whole is far from unified, given the large disparities in income per capita, the different speed of reforms, and the weak trade and investment relations between many of the countries. Nevertheless, levels of business cooperation across borders greatly exceed those prevailing in the late 1990s, and regional integration is becoming a slowly increasing reality.

Private sector development is at the heart of sustainable growth and a successful transition. This study has focused on four prerequisites for such growth: a fair business environment; access to domestic sources of finance; inflows of foreign investment (with associated new skills and processes); and access to trade in international markets. In all four areas the progress since the late 1990s is evident, and in some cases remarkable, but there is scope for further improvement. This summary chapter focuses on a few key recommendations which, if implemented, could advance transition and private sector development in SEE significantly.<sup>1</sup>

## 6.1 Business environment

### Tackling the informal sector

Chapter 2 showed that there is a large informal sector in SEE. A crackdown on informal activities would restore confidence in the rule of law, encourage fair competition

and reduce fiscal pressures through enhanced corporate revenue. It would also be expected to lead to increased lending from commercial banks – not only because the demand for bank loans would increase, but also because bank funds and the number of creditworthy borrowers would rise as well. However, a crackdown could also exacerbate poverty and lead to social unrest. This is the dilemma facing governments in the region. The problem needs to be tackled sooner rather than later, but should be done with an emphasis on the benefits of operating in the formal sector.

There are several ways to encourage small businesses in particular to operate legitimately. Most importantly, registration of businesses should be made easier and more systematic, through the introduction of a database and “one-stop shops”, and through the application of the so-called “principle of silent consent” – meaning that if no objection to a request for registration of a new business is received by the applicant within a given period, then permission is deemed to have been granted.<sup>2</sup> The role of business advisory services could also be expanded, as many enterprises would benefit from guidance on, for example, marketing and business plan preparation.<sup>3</sup> The provision of such support could be linked directly to business registration. In addition, governments could promote measures to ensure that contracts are honoured and to help resolve disputes.<sup>4</sup>

### Liaising with the private sector in identifying key impediments to business

All SEE countries are participating in the OECD-led South East Europe Compact for Reform, Investment, Integrity and Growth (the “Investment Compact”), an initiative of the Stability Pact for south-eastern Europe. The OECD works with each country in the region to devise specific business targets over an agreed time period. Progress on each target is assessed regularly through “monitoring instruments” (see, for example, OECD, 2003b). As a result, lack of progress in any area is visible to all partners of the Investment Compact, with resulting embarrassment to those who are seen to be lagging behind. However, these targets have sometimes been either too ambitious or have not been linked to the concerns of businesses.

There needs to be a stronger correspondence between the investment climate initiatives proposed by governments and the concerns of the private sector and the foreign investor community. This has been recognised by the OECD, which notes that future time-bound targets should more clearly reflect the views of the private sector. This would help in making targets more specific and easier to implement. More cooperation with foreign as well as domestic investors in a particular country can help to identify the key problems that investors face in doing business. Foreign investor associations are active in some countries of the region, such as Bulgaria and Romania where they have shown that they can play an important role in policy dialogue with government on business climate issues.<sup>5</sup>

<sup>1</sup> Key transition challenges facing each country are identified in the EBRD *Transition Report* 2003, while the Enterprise Performance and Policy Assessments (EPPAs), prepared jointly for each SEE country by the OECD and the EBRD, provide detailed recommendations on regulation, taxation, access to finance and other areas that affect the business climate for small and medium-sized enterprises (SMEs). The World Bank's Foreign Investment Advisory Service (FIAS) has also produced reports and recommendations for most countries in the region on the investment climate for foreign investors.

<sup>2</sup> For example, in Montenegro, when a new enterprise submits a registration form to the appropriate authorities and receives no response within four days, it is deemed to be registered (see OECD, 2003a).

<sup>3</sup> The Business Advisory Services Programme, which is donor-funded and based at the EBRD, has operated successfully for a number of years in several countries of the region and may be a model in this regard.

<sup>4</sup> Evidence from the Business Environment and Enterprise Performance Survey suggests that businesses in SEE often forgo trade opportunities with unknown, third-party suppliers in order to avoid potential disputes (see forthcoming monograph by the EBRD and World Bank on “institutional reform for investment and growth in south-eastern Europe”).

<sup>5</sup> The White Papers on business climate published annually by the Bulgarian International Business Association and the Foreign Investors Council in Romania have become key instruments of communication with government authorities.



## 6.2 Access to finance

### Strengthening competition in the banking sector

Chapter 3 showed that bank intermediation remains low across the region, while in several countries there are many inactive, weak and undercapitalised banks in the market. Increased competition would improve the response of banks to lending opportunities in the private sector, lead to lower interest rates for loans and greater banking efficiency, and encourage more demand for loans. At the same time, the pressure of competition would support the consolidation of the sector and greater regional expansion.

In several SEE countries privatisation in the banking sector is not yet complete. The process needs to be accelerated because, as Chapter 3 demonstrated, private banks are more efficient and tend to offer a more comprehensive service to customers than state-owned banks. The presence of reputable foreign banks in the market also helps to build depositors' confidence and increase the capacity of bank lending to the private sector.

### Developing alternative sources of domestic finance

The availability of non-bank sources of finance is limited across the region. This is why SMEs in less advanced countries are forced to seek informal sources of finance and often rely far more on family capital and remittances. Other options need to be explored. Lease financing can play an important role, but the legal framework for leasing has yet to be introduced in some countries (such as Bosnia and Herzegovina) or needs to be redesigned.<sup>6</sup>

In addition, legal and regulatory barriers in the SEE region continue to impede the development of dedicated mechanisms for providing financial assistance to small enterprises. Excessive restrictions in the banking sector, such as high minimum capital requirements, high provisioning requirements to cover potential losses from bad loans and restrictive definitions of

acceptable collateral, should be removed.<sup>7</sup> The challenge remains to find a balance between prudent regulations on the one hand and a flexible framework that facilitates lending on the other.

## 6.3 International sources of capital

### Fair treatment for foreign investors

Chapter 4 showed that net capital inflows to SEE reached a peak of US\$ 10 billion in 2003, while net FDI, at over US\$ 6 billion, was also a record for the region. However, much of this FDI was related to privatisation, and future inflows of this size cannot be taken for granted. In July 2002 all governments in the region signed a formal commitment to common principles and best practice in attracting investment. One of the key measures is to accord foreign investors the same treatment granted to domestic enterprises, unless motivated by security or public order considerations. This is known as the "national treatment" principle.

Although the laws in most SEE countries apply this principle, some exceptions in specific fields remain.<sup>8</sup> For example, foreign investors still face restrictions on equity investments or authorisation and licensing procedures in sectors such as banking, insurance, air and maritime transport, and mining and quarrying. Another common exception to the principle relates to real estate ownership by foreigners, who have limited access to agricultural land and residential ownership in most SEE countries. The elimination of these exceptions is an important prerequisite to the creation of a business-friendly environment and a key challenge for the governments of the region.

### Facilitating the flow of remittances

The outflow of people from a number of countries in SEE during the 1990s has caused enormous damage to the workforce in the region. However, many migrants help those left behind by sending money home. These remittances mainly finance imports – without them, the average standard of living would be significantly lower. However, remittances can also be another source

of investment finance from abroad and, if channelled through the banking sector, can help develop financial intermediation.

Countries in the region can benefit from staying in contact with expatriates and highlighting domestic investment opportunities. The experience of "financial fairs" in the United States for migrant (mostly Mexican) workers may provide a useful lesson for the SEE region.<sup>9</sup> These fairs encourage migrants to use the banking system when remitting money to their home country, so local banks benefit as well. They also provide advice to migrants who may wish to return to their native countries and set up new businesses. In SEE this would help to alleviate the loss of human resources that much of the region suffered throughout the 1990s.

## 6.4 Access to trade

### Enhancing intra-regional trade and cross-border cooperation

Chapter 5 showed that countries in SEE generally trade less than expected, both among themselves and with the rest of the world. Greater regional integration would lead not only to more trade, but also to increased FDI flows (as explained in Chapter 4). Several initiatives should be pursued to promote trade within the region and externally. The bilateral trade agreements that have been signed among countries in the region should be harmonised as much as possible, with a view to an eventual common free-trading area. International technical support will be crucial in setting up such an area and ensuring that it works efficiently. Such support could be made conditional on meeting quantifiable targets in terms of moving goods quickly across borders and reducing corruption.

Other IFI-led initiatives to promote trade and greater regional integration in SEE can also play a role. In addition to the EBRD's Trade Facilitation Programme (described in Chapter 5, Box 5.2), a key example is the World Bank regional project for Trade and Transport Facilitation in Southeast Europe,

<sup>6</sup> The International Finance Corporation (IFC) has promoted the development of leasing arrangements in parts of the region, as well as capacity building and training programmes, through its Southeast Europe Enterprise Development (SEED) programme, initiated in 2000.

<sup>7</sup> These recommendations are discussed further in the EBRD-OECD Enterprise Performance and Policy Assessments (EPPAs) for each country, and summarised in OECD (2003).

<sup>8</sup> See OECD (2003c) for an overview of the existing measures providing exceptions to the national treatment principle in each SEE country.

<sup>9</sup> See World Bank (2003, Chapter 7).



which aims to reduce non-tariff costs to trade and transport, reduce smuggling and corruption at border crossings, and strengthen and modernise the customs administrations and other border control agencies in all countries of the region.<sup>10</sup>

### Developing a marketing culture for exporters

Chapter 1 drew attention to the reputation for instability faced by countries in SEE. While this referred mainly to the legacy of the conflicts in the 1990s, access of enterprises in SEE to markets outside the region has also been affected adversely by the perception that their goods are of low quality. The development of a more aggressive marketing culture domestically and the creation of a network of export promotion agencies abroad possibly linked to the activities of foreign consulates may help to dispel this negative image. The increasing participation of SEE companies in international trade fairs is an important step. Another encouraging sign is the growth of foreign tourism, particularly in Bulgaria and Croatia. Given the potential for further FDI inflows to this sector (see Chapter 4) and the importance of tourism revenues in financing trade imbalances, more should be done to promote the image of SEE countries abroad and also to upgrade the domestic tourist infrastructure to Western standards. In selected cases, a coordinated approach among tourism agencies in the region would help to encourage tourists who want to visit more than one country on a given trip.

## 6.5 Summary

The long-term future of SEE should be viewed with both optimism and caution. The challenges are formidable and the potential pitfalls numerous. However, there are unmistakable positive trends: growth is robust, economic and political stability is returning, and unprecedented investment is flowing into the region. Continuing improvements in the central aspects of this study – business climate, access to domestic finance, foreign investment flows and access to trade – should lead to expanding opportunities and further growth in the medium and long term. The international community can meanwhile retain a vital role by providing even greater access for goods and services from the region, giving selected assistance to those parts of the region that need it most, and being a catalyst for other investors. Ultimately, however, the private sector in the region itself is, and will continue to be, the engine for growth and prosperity.

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<sup>10</sup> See <http://www.seerecon.org/ttfse> for more details on this initiative.

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